READINGS IN INDUSTRIAL FINANCE

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Readings in Industrial Finance

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Preface

The essays included in this volume represent significant contributions to the literature on industrial finance. Each essay provides to the reader an insight into a specific aspect and is expected to deepen his understanding of the theory and organization of industrial finance.

The selections have been made so as to provide a judicious mixture of theory and description. Appropriate passages from the theoretical works of economists such as Keynes, Joan Robinson, Gurley and Shaw, are offered alongside historical-institutional contributions of Goldsmith, Myrdal, Galbraith and others.

Some selections were included specifically with the objective of maintaining a historical perspective considered necessary for a proper understanding of the present problems and developments. At the same time, our attempt has been to restrict the selections to those which are likely to be of durable interest for the study of industrial finance.

The book is intended primarily for Indian readers and much of the material included in it is directly related to Indian institutions and problems. It is useful, nevertheless, to include some discussion of the capital market institutions of other countries in order to keep the horizon wide and to provide some enlightening comparisons.

Over the last decade or so, the problems of industrial finance, in India in any case, have acquired new social dimensions inasmuch as financing methods and institutions affect the control of industry, distribution of finance and concentration of power. These considerations are now an important input in the formulation of government policy towards private industry in India and have been an important influence in shaping the structure and policies of industrial financing institutions. The essays of Hazari, Myrdal and Galbraith and the Report of the Study Group appointed by the National Credit Council on 'Organizational Framework for Implementation of Social Objectives' are particularly enlightening in this respect.

The idea of this collection of readings originated some years ago when I was teaching at the Delhi School of Economics. I found that students faced considerable difficulty in locating the widely scattered original sources. Also, few libraries can afford to have multiple copies of periodicals and the new ones are unable to acquire publications which are out-of-print. Not many libraries would be able to boast of possessing all the original sources—periodicals, official reports and books—from which these selections have been drawn. It is hoped that students and teachers will find this collection stimulating reading.

The selected readings have been classified under seven sections as follows: (1) Capital Market, (2) Entrepreneurship, (3) Commercial Banks, (4) Development Banks, (5) Securities Market, (6) Foreign Private Investment, and (7) Social Perspective of Private Industry.

An introductory note is given at the beginning of each essay. This note is *not* intended to comment on the author's views but simply to guide the reader broadly about the nature and content of each essay. The purpose of this collection is to present thought-provoking ideas and to let the reader form his own views about them.

Our most grateful thanks are due to the authors, publishers and institutions who owned the copyrights and who have most liberally given us permision to reprint the material.

L C GUPTA

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1

Factors in the Development of Capital Markets*

George Rosen

This essay provides a general view of the development of capital markets in various countries. It notes in particular that the structure of the capital market has varied from country to country, depending upon a variety of economic and social factors. The development of the Indian capital market is also examined against this wide international background.
Editor

The process of industrial growth requires, as one of its accompanying structural changes within the economy, the development of a capital market that will provide an adequate and properly distributed supply of finance to those entrepreneurs —whether public and private—who are setting up new industrial plants or expanding existing ones. While finance itself produces no output until capital equipment and raw materials are purchased with it, the availability of money and credit permits entrepreneurs to gain control of the real resources which enable them to engage in industry by producing and distributing industrial products. At an early stage of development the would-be entrepreneurs normally find their own financial resources inadequate and must resort to external sources. The market through which

*Taken from George Rosen, *Some Aspects of Industrial Finance in India*, pp. 1–9. Reprinted with permission from The Free Press, New York, © 1962 by the Massachusetts Institute of Technology.

such finance is made available is the capital market. This consists of those institutions through whose services the would-be demanders of finance are able to meet or gain access to either direct suppliers of financial capital or various intermediate supplying institutions to which, in turn, ultimate suppliers are willing to entrust their financial resources in the hope of a return.

It is clear that the structure of the capital market has varied from country to country, depending upon a wide variety of factors —the history of the country, including banking history, the extent and type of business experience, the role of political factors, and the role of government.[1] Gerschenkron has summarized many of the varying historical experiences before 1914 in European countries; they are relevant to the present underdeveloped countries:

> The industrialization of England had proceeded without any substantial utilization of banking for long-term investment purposes. The more gradual character of the industrialization process, and the more considerable accumulation of capital, first from earnings in trade and modernized agriculture, and later from industry itself, obviated the pressure for developing any special institutional devices for provision of long-term capital to industry. By contrast, in a relatively backward country capital is scarce and diffused, the distrust of industrial activities is considerable, and finally there is greater pressure for bigness in industrial processes....To these should be added the scarcity of entrepreneurial talent in the backward country.
>
> It is the pressure of these circumstances which essentially gave rise to the divergent development in banking over large portions of the continent as against England....Between the English bank essentially designed to serve as a source of short-term capital and a bank designed to finance the long-run investment needs of the economy there was a complete gulf....The continental practices in the field of

[1]The two best general reviews are: for the present underdeveloped countries, two articles by U Tun Wai in the International Monetary Fund (I.M.F.) *Staff Papers*, August 1956 and November 1957; for the developed countries, Alexander Gerschenkron, 'Economic Backwardness in Historical Perspective', in Bert Hoselitz, ed., *The Progress of Underdeveloped Areas*, University of Chicago Press, Chicago, 1952.

> industrial investment banking must be conceived as specific instruments of industrialization in a backward countries.[2]
>
> ...[In Russia] the scarcity of capital...was such that no banking system could conceivably succeed in attracting sufficient funds to finance a large-scale industrialization; the standards of honesty in business were so disastrously low, the general distrust of the public so great, that no bank could have hoped to attract even such small capital funds as were available, and no bank could have successfully engaged in long-term credit policies in an economy where fraudulent bankruptcy had been almost elevated to the rank of a general business practice. Supply of capital for the needs of industrialization required the compulsory machinery of the government, which, through its taxation policies, succeeded in directing incomes from consumption to investment.
>
> But as industrial development [in Russia] proceeded apace and as capital accumulation increased as a result of this development, the standards of business behaviour were growingly Westernized. The paralyzing atmosphere of distrust began to vanish, and the foundation was laid for the emergence of a different type of bank. Gradually the Moscow 'deposit' banks [of the English type] were over-shadowed by the development of the St. Petersburg banks that were conducted upon principles that were characteristic not of English but of German banking.[3]

In the United States before the Civil War the development of the local unit banking system, in contrast to the British branch banking system, was in response to the needs of local entrepreneurs in the frontier areas, who required access to finance for their own local needs against the types of security—most often land—available to them as opposed to the types of security required by the English and the larger Eastern banks.[4]

There is evidence that banks were major instruments in financing industrial expansion in Japan, too, but by a process of

[2] Ibid., pp. 12–13.

[3] Ibid., pp. 18–19, 21.

[4] Bray Hammond, *Banks and Politics in America, from the Revolution to the Civil War*, Princeton University Press, Princeton, 1957, gives an

'overloaning' as compared to more traditional British banking practices (since in Japan the loan-deposit ratio exceeded 90 per cent).[5] Overloaning was made possible by the relatively easy facilities for borrowing from the central bank and by the very close relationship between the major banking houses and the leading industrial and commercial firms.

We must distinguish between those countries which have (or are) developed by the activities of the private sector primarily, or with a large private sector relative to the public sector (i.e., a mixed economy), and those which permit no private sector and are entirely planned. In the latter the problem of finance is not one of access, since the financial resources may be derived by taxes (or profits of the government plants) of one type or another; funds can then be made available through a central agency to the managers of new enterprises as a matter of routine following the decision to start the enterprise. In such economies the problems are more of the character of project control to insure that the funds are used by the managers for the purpose requested, and on the macro-economic level of inflation control to insure that prices do not rise too rapidly and interfere with the growth process. In economies in which a private sector plays a large role, and in which there is relatively free entry of newcomers into industry, the finance problem is a key one. Would-be entrepreneurs must have access to financial resources normally beyond what they themselves may privately own. Moreover, funds must be channelled to them, and choice must be exercised with respect to recipients—which in part at least will be determined by the price mechanism, with the rate of interest (or structure of rates) reflecting the demand for, and supply of, finance. It should be noted that, where there has been a large accumulation of capital and experience, as in England in the past, the entrepreneur's own resources may be quite adequate; if, as today, these

excellent description of this process. Until the Civil War also, the banking system was consistently 'overloaned' by British or Indian standards, with loan-deposit ratios of well over 100 per cent. See U.S. Department of Commerce, Bureau of the Census, *Historical Statistics of the U.S., 1789–1945*, Government Printing Office, Washington, D.C., 1949, pp. 261-263.

[5]See S. Tsuru, 'Economic Fluctuations in Japan, 1868–93', Statistical Appendix in his *Essays on Japanese Economy*, Kinokuniya, Tokyo, 1958, p. 148.

prerequisites do not exist or the rate of investment desired is beyond the rate of profit accumulation the entrepreneur must seek other sources of finance.

What is the situation with respect to the function of capital markets in the underdeveloped countries which are currently planning rapid industrialization with at least some private enterprise? Little is known, except in largely qualitative terms, of how the capital markets do in fact operate in these countries. Historically in India there have been two quite separate capital markets. The older one, and probably by far the more important one even today, is that of the indigenous moneylender, who frequently is also the large landholder and trader as well as the banker for his village or region.

To consider India as a country with a homogeneous population all at the level of subsistence with no savings or investment is grossly misleading. Although quantitative data are lacking, it is clear from past reports of various official commissions and academic studies that:

> ...the rural population consists of various classes, some of whom at least, such as big landholders, cultivators of economic holdings and the thrifty sections of small holders and tenants, and traders, normally possess ...a margin for savings. The surpluses ... have generally been invested in the purchase of land, in acquiring additional livestock, and in agricultural improvements. ...Sometimes a portion of such surpluses has also flowed into urban enterprises such as trade, the establishment of processing industries and the acquisition of urban real estate.[6]

This quotation omits two other investment outlets: money-lending both for subsistence and near-subsistence 'contingency expenses', whether for unusual social purposes and more persistent direct consumption purposes in a poor or even

[6] *The Report of the Rural Banking Enquiry Commission*, G.O.I. Ministry of Finance, Delhi 1953, Ch. II. Mr. Asok Mitra has made some preliminary estimates, which he has kindly permitted me to cite here, of income distribution in the rural sector. He has computed that in 1953/54, although almost 230 million of the total agricultural population had a per capita income of Rs. 112, the 31 million of the agricultural population owning land of more than 15 acres had a per capita income of Rs. 858. 'A bland statement that per capita income in

normal harvest period or for productive purposes arising out of loss of productive equipment;[7] and direct investment in newly mined or imported gold and precious metals for reasons of liquidity, safety, and as a hedge against rising prices It is reasonable to assume that the distribution of investment among these various alternatives is based on economic considerations, that is, to maximize the return from all investments consistent with a desire to maintain certain levels of liquidity, and that adjustments among investments are made on maximizing principles within the social framework of the Indian village. The interest rates earned on moneylending in the rural sector in India are high, although it is again difficult to determine the exact rates. (Various surveys have found a minimum of 16 per cent and a maximum of 30 per cent, although in certain areas the rates at times have risen to as high as 100 per cent.)

Because of his high potential return in agriculture and moneylending as well as his ignorance and fear of investment in industry or urban activities, it is clear that the landed moneylender would have little incentive to invest in industry. Moreover industrial investment *per se* would be relatively unattractive to him in the earlier stages of industrialization; there is little reason for him to believe that his single investment would be successful without the external economies to be derived from investments in related fields and in overhead facilities such as transport and power necessary for industry. Investment in commerce, both in the form of stocks of industrial goods flowing between the factory and the peasant and in cash crops grown in his area, would normally develop out of his activities. If his returns from investment in agriculture

agriculture is barely Rs. 200 per annum assumes a new operational reality when accompanied by the valuable additional comment that, for at least one-tenth of the agricultural population, the level of per capita earnings is at least 4 times as much' ('Tax Burden of Agriculture', mimeographed draft, p. 23).

[7]An excellent analysis of this process as it occurs in a village in Orissa is given in F.G. Bailey: *Caste and the Economic Frontier*, Manchester University Press, Manchester, 1957.

Professor K.N. Raj's work on the structure of rural interest rates, as presented in an unpublished lecture at the Centre for International Studies, Massachusetts Institute of Technology was also most stimulating.

or moneylending diminish as a result of government policies or other developments—land reform, improvements in local storage and transport facilities, or government financial assistance to the peasantry—other investments might become attractive. Under any circumstances, most rural investment is carried out on a personal, family, or community basis with no recourse to the wider public or to external sources. This situation partly reflects an absence of such sources or means of recourse, but even more a lack of confidence in groups or individuals outside one's own group. Thus the limit of investment capacity is the resources of the investing group with only minor external support possible from other members of the family or community.

In India, and in other formerly colonial countries, there were and are also the rudiments of a modern banking system and capital market. They arose originally out of the requirements of foreign investors who transacted business within the country, usually in connection with foreign trade and transmission of funds to their home country. The incentives for these investors were profit possibilities higher than at home, often through the exploitation of natural resources such as oil. They needed a modern banking system to carry out the processes of foreign trade — most important, to transfer foreign exchange or to supply it, and also to meet credit requirements between order and payment. The first banks in India were set up for these purposes; they were naturally modelled on the British banks or later were branches of English banks: The English investors normally invested their own resources and plowed back their earnings. They supplied their own capital and introduced the managing agency system to spread their entrepreneurial skills widely and to distribute finance among the enterprises of the agency which required it. The only need for financial assistance was for short-term purposes—credit to pay the farmers for the cash crop before processing, to finance the shipment of the finished product to the market—and to meet the foreign trade needs of the business group. There was little demand for long-term credit under such circumstances; the banks maintained their English character as institutions for the supply of short-term credit.

Under the stimulus of either foreign example or self-

recognized opportunities, indigenous businessmen also began to shift from commerce to industry. Some entered industry indirectly as creditors of enterprises that had failed or were near failure with debts unpaid, as did the Sarabhai family—one of India's leading industrialist families—which entered cotton textile manufacturing at the end of the nineteenth century; others made money in commerce or speculation and were attracted into industries which they thought would be successful in India, for example, J. N. Tata, who originally made his capital in trade with China and invested it first in cotton textiles and later in power, steel, and other fields. During the First World War, as imports into India were cut off, industrial investment became more attractive. At this time the Birla family, among others, moved into industry from trading and moneylending. The move to industry was also stimulated by the Swadeshi movement, which aimed at encouraging consumers to 'buy Indian'.

With the entry of Indian entrepreneurs into industry, Indian-owned banks were also set up, in some cases by industrial entrepreneurs. But the larger capital needs of Indian industry were financed in traditional fashion from the entrepreneur's own resources, or those of his family or community. In certain areas, most notably in the textile mills of Ahmedabad, major sources of finance were the fixed deposits made by the public into firms run by well-known individuals or groups; and for these deposits of a year or more the mill paid very favourable interest rates. The Indian entrepreneurs also adopted the British device of the managing agency. The system made it possible for an individual or a family to control a variety of firms; even more important, by investing in other firms of the same group the profits of an old successful enterprise could be shifted to a new one in the same group which needed capital.[8] Again, as in England, the long-term financing needs of a firm were met from internal sources; with a relatively slow rate of growth there was little need to go to external sources for this type of capital. The Indian-owned banks, modelled on the British, thus performed a similar function—the supply of short-term credit

[8]Dr. R.K. Hazari is currently exploring the form this procedure is taking today. His findings should be a major contribution to our knowledge of the Indian managing agency system.

against tangible, rapidly turned over assets in the form of stocks of raw materials and finished products.

Industrial development and urbanization were accompanied by the rise of a small urban middle class in India. This was a class with some savings, but it was increasingly cut off from the village and increasingly dependent upon its own savings for its future capital needs. To meet the needs of this class for long-term security, insurance companies arose. Small savings were invested in these companies, which in turn invested in the securities of industrial enterprises. At the same time, some of the members of the urban middle class, as well as a few of the wealthier rural families, desired to invest on their own, and there was a demand on the part of the rising larger urban financiers and industrialists for speculative investment of otherwise idle funds. Stock exchanges arose to provide a centre for such purchases and sales. However, the middle class investment demand was for long-term purposes and for investment in the safest companies—very often foreign-owned; the speculative demand was concentrated in a few securities which promised quick gains, but such investment was largely limited to a few wealthy individuals. Apart from the hazards of starting an industry, the lack of confidence in most Indian businessmen by potential investors made it unlikely that any but a few domestic firms could raise money by public stock issue.

Thus at the start of its programme of industrialization, in which private firms were to play a large role, India had a large unorganised money market which met the demands for funds on the part of the rural and poor urban population; an almost unrelated modern banking system, the main purpose of which was to supply the short-term capital needs of firms whose longer term requirements were largely met from the internal sources of the firm or the ownership group; and a security market which contributed to meeting the longer term investment needs of only a few firms. With industrialization projected on a large scale, changes were required to meet the needs for finance which would exceed the capacities of the traditionally operating institutions.

The purposes of this book are to see how two of India's major financial institutions—the organised banking system and

the life insurance system—have been meeting the new industrial financing requirements, to examine the operation of the special financial institutions set up in part to deal with the needs the banking system had not met, and to estimate the future financial demands of the private sector and explore certain methods for improving the effectiveness of the existing Indian system to meet those demands.

2

The Process of Investment*

William Diamond

This essay sets a broad perspective to the problem of financing industrial growth. The author stresses the point that the availability of finance is closely linked to a host of other equally important factors, all of which together determine the rate of productive investment. Investment may be inhibited by the inadequacy of savings or of financial institutions to mobilise whatever savings are available, by the shortage of entrepreneurship and of technical and managerial talent, by weaknesses in the legal framework governing corporations and financial markets, by the inadequacy of infrastructure, and by faulty fiscal policies. Many of the inadequacies tend to reinforce each other and are deeply engrained in the economic and social structure of the particular country. The policies and methods of development banking institutions should be based on a proper appreciation of these factors in the particular context and stage of an economy.

Editor

Investment lies at the heart of economic development. It is not the only requisite for development, for development may also come about as a result of an increase in the labour force or

*Taken from William Diamond, *Development Banks*, The John Hopkins Press, Baltimore, 1957, pp. 7-18. Reprinted by permission.

a strengthening of economic incentives or the spread of literacy and technical knowledge or a change in economic institutions and organization. Moreover, one may argue about whether a rising level of income is the cause or the consequence of increasing investment; for the very fact that income grows, whatever the reasons, will itself create a need for new investment. In any case, income and capital move hand in hand and investment is essential to the process of development.

INGREDIENTS OF INVESTMENT

In that process, finance is required for two purposes. It is required in long-term form for the creation or acquisition of fixed assets such as land, buildings and machinery. It is also needed in short-term form though no less permanently to be used as working capital, to tide an enterprise over a 'season' or a production process or to finance inventories. With economic growth, the need for both types of finance increases.

The traditional association of long-term finance and fixed assets on the one hand and of short-term finance and inventories, on the other, and the traditional sharp distinction between long-term and short-term finance, are not always clear-cut or real. For the finance required to raise and maintain at an appropriate level the stock of raw materials required for processing may be considered long-term; and in growing enterprise the finance required to replace a machine or to expand a plant may be obtained or desired on medium term. Short-term credit may be used for long-term investment; indeed, the provision of short-term loans which are renewed indefinitely is a practice not uncommon in developed as well as underdeveloped countries. Moreover, short- and long-term financial resources are to some extent interchangeable; for an enterprise which can borrow the former may in the process be able to release some of its own resources for long-term investment.

Thus, in India, a special Committee on Finance for the Private Sector found that

> a part of the advances of commercial banks to industries, for purposes of working capital, though ostensibly short-term, is allowed to be renewed from time to time. It is a matter of common experience that although

> these advances which are largely in the form of cash credits are given for the purpose of requirements of working capital, a part of these facilities operates to release the borrowers' funds for long-term expenditures. Though this part of the finance revolves or rolls over, in actual effect it does serve the needs of providing finance for long periods to a certain extent.[1]

On the other side of the world, a World Bank consultant found a similar situation in Colombia.

> Short-term commercial credits have been resorted to by industrial corporations to carry inventories and to finance operations often upon the understanding by the borrowers that credits would be renewed. In this roundabout way, commercial credit has become an imperfect substitute for long-term industrial capital.[2]

In Europe, a special report sponsored by the European Productivity Agency of the Organisation for European Economic Cooperation (OEEC) called attention to the 'illusory' character, not always recognized 'by practical bankers', of the distinction between 'provision of credit and provision of capital'.[3]

Although the line between fixed and working capital, between short- and long-term funds, is not always clear-cut, it is important to make the distinction, especially in dealing with countries where capital is scarce and where long-term expectations are considered so uncertain that available resources are used in ways which permit quick withdrawal or liquidation. There the money market may be adequate while the capital market is narrow and insufficient. 'Business' may have all the financial facilities it needs while 'investment' is seriously hampered.

The process of investment is not a simple one, for it involves saving out of current income and the risking of that

[1] *Report of the Committee on Finance for the Private Sector*, Bombay, 1954, p. 45.

[2] *Report on the Colombian Capital Market Submitted by Alfonso Manero to the International Bank for Reconstruction and Development*, unpublished, Washington, D.C. July 1952, pp. 10-11.

[3] *The Supply of Capital Funds for Industrial Development in Europe*, Paris, 1957, pp. 19-40.

saving in some productive effort. It implies a level of individual income high enough to permit savings, a willingness to forgo or an ability to force others to forgo some consumption today for more income and hence more consumption tomorrow, and the presence of persons or institutions (private or public) who are prepared to take advantage of opportunities for investment and to risk those savings in expansion and in new activities. It implies also that the persons or institutions concerned will have the managerial, administrative and technical experience necessary to use effectively the capital they risk.

A large part of investment is carried out directly by those who save—by the farmer who clears a field or the producer who plows back his profits or a government which applies a part of its taxes to building new roads. This is an important way of saving and investing, not only in underdeveloped countries but also in advanced countries. But another part of investment results from a transfer of savings from those who save to those who invest. This transfer takes place through that complex of institutions called the capital market, to which individuals, firms or governments may resort. A capital market implies not only intermediary institutions, such as banks, insurance companies, investment trusts, issue houses, stock exchanges, etc. It also implies the existence of savers (including business corporations) willing to entrust their savings (or surplus funds) to others in return for interest or profit, and of potential investors willing to borrow or otherwise to obtain the savings of others for a price.

THE ENTREPRENEUR AND HIS ENVIRONMENT

In underdeveloped countries one or all of these requisites for investment is often lacking. Attention is usually concentrated on the shortage of capital, for that shortage is often considered the main obstacle to development. This is, of course, neither always nor everywhere the case, although individuals and individual enterprises, at all times and everywhere, may be hard put to it to find the capital they need. When people live on the fringe of subsistence, their savings may be insufficient. But they are never non-existent; and it is difficult to avoid the conviction that in many underdeveloped countries savings are

in fact higher than they are thought to be, and that more could be mobilized for productive investment. Relevant in this connection are the hoards accumulated from past savings, the often heavy expenditure for ceremonial purposes, the many ways in which savings are wasted or left idle or used 'unproductively'; in short, the failure of savings and accumulated wealth to contribute to capital formation.

As the United Nations put it in one report,

> if the other factors are available and the economic climate not too unfavourable, local capital sometimes responds with unexpected readiness to the initiative of local entrepreneurs. The first large iron and steel plant in India for example....was financed entirely by domestic capital, collected in three weeks from large and small savers, after the entrepreneur J.N. Tata had failed to raise the requisite £1,630,000 on satisfactory terms in London.[4]

In Pakistan, 1954, despite the widespread conviction that it would be impossible, the government-owned Industrial Development Corporation was able to sell with ease more than half the equity in its paper mill to private investors. More recently, a World Bank mission to India reported that 'in many underdeveloped countries, including India, the amount of capital available for investment is often surprisingly and inexplicably large' and that 'very few of the many businessmen consulted by the mission on this subject (of industrial investment) appeared to regard financing as a serious problem'.[5]

A low level of investment may thus be the upshot, not only of poverty but of social values or of economic environment which direct savings into unproductive uses, or of inadequate opportunities to use savings productively.[6] In such circumstances, economic development may be not so much a matter of increasing savings as of changing the existing pattern of investment and directing savings into more productive channels. For growth often depends 'more on where and

[4] United Nations, *Processes and Problems of Industrialization in Underdeveloped Countries*, New York, 1955, p. 38.

[5] *Current Economic Position and Prospects of India*, unpublished, AS-54a, Washington, D.C. August 1956, p. 77.

[6] See Charles Wolf, Jr. and Sidney C. Suffrin, *Capital Formation and Foreign Investment in Underdeveloped Areas*, Syracuse, 1955, Ch. II.

how' capital is invested 'than on the absolute quantity of savings'.[7]

The term 'productive investment' has been used here. Observers of entrepreneurs, having in mind the need for economic growth and the kinds of socially useful investment conducive to it, are prone to condemn entrepreneurs in underdeveloped countries for their 'unproductive' activities, their persistence in traditional lines of activity and their lack of 'initiative'. These characteristics are often contrasted to the 'rationality' of European or American entrepreneurs who, led on by the quest for profits, display initiative in the creation of new enterprises. Governments often profess this view of their own citizens as a justification for undertaking themselves what is not otherwise being done. The fact is, of course, that it is difficult to find a country in which most people do not act rationally in terms of their own goals and knowledge. It is equally difficult to find one in which people are not pursuing profit actively and directing their savings into channels which the circumstances make rational and which are highly productive in terms of individual incentives. In the conditions prevailing in many underdeveloped countries—instability of governments and of government policy, changing (and often declining) value of money, unskilled labour force, lack of experience with modern techniques, limited markets—it is rationality, not the reverse, that keeps most investment channelled in the traditional fields of real estate, commodity speculation and foreign trade. These are the fields in which the investor can find the security, profitability and liquidity which justify his investment. The banking community, of course, works with the same short time-horizon.[8]

The whole range of circumstances affecting the expectations of enterprise makes up what the Indian Committee on

[7]Thomas C. Cochran, 'The Entrepreneur in American Capital Formation', in National Bureau of Economic Research, *Capital Formation and Economic Growth*, Princeton, 1956, p. 372.

[8]See Henry G. Aubrey, 'Investment Decisions in Underdeveloped Countries', and Marion J. Levy, Jr., 'Some Social Obstacles to "Capital Formation" in "Underdeveloped Areas" ', in *Capital Formation and Economic Growth*, pp. 397-520; Aubrey, 'Industrial Investment Decisions: A Comparative Analysis', *The Journal of Economic History*, 1955, XV, pp. 335-51; and Benjamin Higgins' criticism of the foregoing in *The Journal of Economic History*, 1956, XVI, pp. 350-55.

Finance for the Private Sector called 'economic climate'.

> It is a truism (the Committee reported) that while lack of finance might inhibit investment, an increase in the supply of finance will not by itself bring about an increase in investment. Cheap or plentiful credit cannot *per se* be an incentive. Private investment will come forth only if there is an expectation of reasonable compensation for the risks it has to undertake. The investor's expectations of the returns he is likely to get on his investment are coloured not only by the purely economic factors of demand and costs but also by various political, social and psychological elements that make up the environment in which he has to function. These semi- or non-economic factors could well limit his willingness to invest and undertake risks, even when a proposition seems worthwhile on purely economic considerations.[9]

Given the appropriate climate (including generally accepted goals which can be attained by economic activity; access to capital, labour and skills; opportunity to enter an industry, etc.), entrepreneurs can emerge quickly in an environment in which they were hitherto conspicuous for their paucity or timidity. This was the case in France in the middle of the nineteenth century, in Russia toward the end of that century, in Mexico during World War II, in Turkey shortly thereafter.

Willingness and ability to change prevailing habits are important because economic development normally entails going into new activities, notably into industry. It requires not only an expansion of customary activity, of agriculture and of trade, particularly internal trade, but also the growth of transport facilities and public utilities, of manufacturing and mining. The entrepreneur is called upon not only to expand his existing activity, but more important, to enter a relatively or entirely new field: a field demanding technical and managerial knowledge which he does not have and labour skills which his country does not have; demanding larger total investment and a large fixed investment; perhaps yielding lower profits in its early stages if not combined with other new activities for which responsibility rests elsewhere; and this in a market whose size

[9] *Report*, p. 14.

may be small and whose stability may be uncertain. In short, the entrepreneur is called upon to enter a field of activity much riskier and at first perhaps less profitable than the normal activities of the business community.

The bankers share the customary inhibitions of the rest of the business community and are as likely to be reluctant to finance industry as the businessmen are to enter that field. Such capital as is mobilized and made available is usually available only to the traditional, well-known activities and for only short periods. Very often in underdeveloped countries there is no significant shortage of short-term credit, for which the demand and hence the returns are always very great although the terms on which it is available may be onerous. Commercial banks, families and individual moneylenders are usually able to provide most if not all the credit that is required for ordinary commercial purposes. But it is the common experience that they do not provide it for long-term investment or for new forms of economic activity, particularly if there is a long delay before a return is realized. In this the bankers of underdeveloped countries follow the principles if not the practice of the advanced countries from which they imported their banking institutions.

MOBILIZATION OF SAVINGS

Another problem that arises concerns the size and hence the cost of the new investment. The largest concentrations of capital are needed for highways, railways, electric power, irrigation and other public works. The capital required for these fields is usually far beyond the reach or interest of any single person or group. Indeed, they are likely to be marked out for government initiative and action, and financed from the capital the government can mobilize through taxation and borrowing. But they are, to a large extent, only means to the production of goods, in both primary and secondary industries which generally depend on private initiative. Mining and industrial enterprises normally call for larger outlays of capital per enterprise and per man than the entrepreneurial community may be accustomed to in its traditional commercial and agricultural enterprises. The initial outlays in such fields may

come, as they often did in the past, from the small individual entrepreneur; but more may be needed than he can provide, particularly since industrial enterprise is likely to require new men and not simply the conversion of the older and already wealthy mercantile and land-holding community.

To meet the need for these large outlays, there must be institutions to mobilize savings and transfer them from those who save to those who are prepared to invest. The problem of mobilizing savings is particularly serious where new forms of economic activity are involved, as in the expansion of industry in an underdeveloped country, for savings tend to move within the sector in which they are generated. The industrial sector, by definition small and incapable of producing quickly the resources it needs, must look elsewhere, particularly to the commercial sector. In the course of economic development, industrial enterprise has come from many segments of the community (and chiefly from the merchants) in which capital and skill grew by slow accretion. Where development is just starting, or occurring rapidly, the industrial entrepreneur often has little or no savings accumulated from earlier profits and must resort to family, friends or institutions for his capital. Family and friends, the traditional stand-bys, have the advantage sometimes of being more venturesome because less careful; an institution tends to have what Lord Piercy, Chairman of the Industrial and Commercial Finance Corporation, called an 'institutional conscience' and hence is 'a less comfortable sleeping partner than the private person'.[10] But transferred or institutional savings are particularly important because they result in broadening the range of investment that can be financed and they improve the utilization of resources. Unfortunately, underdeveloped countries are characterized by the absence or inadequacy of institutions which can mobilize and transfer savings.

The institutions required to mobilize, transfer and invest savings are not simply organizations to collect and disburse funds. Legal codes and practices are also involved. Savers and investors may require certain safeguards before transferring savings to others or investing them in enterprises operated by

[10]From address on 'The Provision of Capital for Industry' October, 11, 1950, cited in Brian Tew, 'The I.C.F.C. Revisited', *Economica*, 1955, XXII, p. 225.

others. These safeguards include sound banking practices and protective regulations, laws which permit and facilitate limited liability and corporate organization, an administration of law and justice that inspires confidence, the existence of persons or institutions to facilitate the transfer of rights and interests. An investor may be concerned about the marketability of the real assets lying behind the security he holds, which also depends in part on legal codes, on the provisions which bear on legal title and which permit or restrict the sale of land, fixed capital, goods, etc. These in turn may be linked to the laws of inheritance, the family system and land registration. There is the further problem of the existence of a market for the assets. Even if they may legally be sold, will there be someone to buy them? Moreover, adequate laws and institutions are not in themselves sufficient. The entrepreneur must be willing to make use of them; for instance, he must be willing to use the corporate form and in large enterprises to permit the distribution of equity. This may not always be the case; indeed, it rarely is in underdeveloped countries, where the tradition of individual or family ownership is very strong.

The laws, institutions and practices referred to here are those required to sustain a capital market. The institutions include savings banks, commercial banks, stock exchanges, issue houses, etc. The laws concern security, liability and business organization. The practices involve the techniques and traditions of enterprise and finance. These elements are no less important to economic development than capital and production techniques. Their underdevelopment can be an important obstacle to economic growth. In the face of this intricate network of problems, it is small wonder that in the past government securities have generally been the first securities to be marketed in most countries and that in some underdeveloped countries today the government is the most important single institution for generating and mobilizing savings.

The problems referred t[illegible] in quite different ways for different types of inve[illegible] [illegible]se pressures have been brought to bear o[illegible] governments [illegible] se special attention is being directed [illegible] development[illegible]l purposes, the classes of investors [illegible] which governments a[illegible] often particularly concerned are [illegible] farmer, the small [illegible]sinessman and

the large industrialist. To provide leadership and finance to such different groups calls for a variety of approaches and often a variety of institutions. For instance, the cost of administering financial assistance to farmers is very high compared with that in industry; salable security is often difficult to get; and the transmission of the new techniques required to make effective use of financial resources—involving a multitude of families rather than a relative handful of industrial managers and technicians—makes the problem of farm credit quite different in kind from that of industrial credit. Small industries and handicraftsmen suffer from some of these same disadvantages, are notoriously weak in management skills and are sometimes in greater need of working capital on reasonable terms than of long-term resources.

Thus when productive investment is inhibited by genuine shortage of long-term finance, those shortages may reflect inadequate savings; but they may also reflect a lack of appreciation of new opportunities or a shortage of persons willing and able to grasp them or the absence of institutions to mobilize savings or the inadequacy of financial techniques and their supporting legal structure. The fact that there are unexploited opportunities for investment despite the existence of savings suggests that the lack of demand for capital may be as serious a bottleneck as the inadequate supply of capital. Indeed, shortage of capital is closely linked in underdeveloped countries with shortages of entrepreneurship, of technical skills in both planning and operating an enterprise and of managerial talent. The lack of enterprise may well be, in a particular environment, the critical bottleneck. The lack of technical or managerial competence in planning and operating an enterprise may equally inhibit productive investment, particularly when the financial resources required must be borrowed or otherwise obtained from individual savers or institutions. Most likely, the insufficiency or misdirection of investment reflects a combination of these factors, for they are rarely present in isolation. These various shortages and inadequacies, which are not easily relieved and tend to reinforce each other, may derive from many sources and are deeply engrained in the economic and social structure of the particular country concerned.

HOW MUCH CAN A DEVELOPMENT BANK DO?

This cursory review of the process of investment has two purposes:

(1) to stress the need to understand the problems which, in any given country, a development bank must face and is intended to deal with and

(2) to make it clear that a development bank will not solve all those problems and that, indeed, it may not be able alone to solve any of them.

A development bank is designed to supply one or more of the essential ingredients of effective investment. Which? Is medium- and long-term capital in short supply? If so, why? Are the nation's savings too low, or can they not be mobilized, or are they being misdirected? Or is it enterprise which is lacking? Perhaps capital is available, but no one is prepared to use it in productive ways. Why not? Are the businessmen too cautious or are opportunities lacking? And if the former, what holds the businessman back? What are the economic or social or institutional obstacles? Is there insecurity or lack of confidence in the future? What kinds of policies and laws can be formulated to increase that confidence? If opportunities are lacking, is it because of inadequate resources or because the market is too small? Perhaps there are opportunities and persons who want to seize them. Do they know how to do so? Do they have the technical and managerial competence to plan, establish and operate an enterprise in a new field of activity, often requiring the importation of new machines and techniques? The answers to such questions as these will have much to do with the way in which a development bank is set up, the manner in which it is financed, the direction and method of its operation, and the kind of personnel it needs. It follows, therefore, that one of the first prerequisites for the establishment of a development bank is an examination of the specific economic and institutional environment in which it will operate and an understanding of the main obstacles to productive investment.

It should be clear, too, that a development bank, however broadly conceived, is not capable of dealing with all these problems by itself. A development bank is one instrument

among many, all of which need to be used consistently and in conjunction. The country's monetary and fiscal policies, for instance, affect the working of the bank. Selective credit controls designed to influence the movement of funds in one direction or another may work against the objectives of a development bank. Or the tax system may discourage precisely the kind of investment that a development bank is designed to encourage. Or the persistence of inflationary monetary conditions may make it impossible for a development bank to borrow additional resources from the public and may result in the depreciation of its capital. This is not to suggest that monetary and fiscal policies should be governed by the requirements of a development bank. But it should be noted that these policies may place obstacles in the way of achieving the objectives of the development bank, that some conflict is more or less inevitable and that where a development bank is a governmental institution, coordination of its activities with other government institutions and policies is necessary.

Conversely, efforts by a development bank to encourage the growth of a capital market will run into difficulty if the legal codes of the country make conditions difficult for corporate enterprises or if appropriate financial instruments are not available or if entrepreneurs are distrustful of corporate organization. Revision of legal codes as well as other measures may be required, about which the development bank may be able to do nothing directly, apart from identifying problems and directing the government's attention to them. This does not mean that before creating a development bank a government must import a great many new institutions and completely overhaul its legal codes. It does mean that a government which wants to promote economic development should be prepared to encourage the growth of institutions necessary for such development, to provide the kind of legal framework they require and to pursue the policies which will induce the volume of savings and the kind of investment it is seeking to bring about.

3

Scope and Function of the Capital Market in the American Economy*

Raymond W. Goldsmith

This paper is a lucid exposition both of the functions performed by the capital market mechanism and of the institutional structure of such mechanism. While the functions of a capital market are described in general terms, the institutional structure is a description of the U.S. capital market.

Editor

ORIGIN OF THE CAPITAL MARKET IN THE SEPARATION OF SAVING AND INVESTMENT

A market for new capital, apart from transactions in existing financial and real assets, exists because in a modern economy saving (the excess of current income over current expenditures on consumption) is to a large extent separated from investment, i.e., expenditures on durable assets usually defined as new construction, equipment, and additions to inventories and excluding education, research, and health.[1]

*Taken from Raymond W. Goldsmith, *The Flow of Capital Funds in the Postwar Economy*, National Bureau of Economic Research, New York, 1965, pp. 22-37.

[1]For an individual economic unit, investment also includes the acquisition of existing tangible assets, but such acquisitions are offset by equivalent sales in a closed economy.

In any given period every economic unit either saves or dissaves—if we ignore the relatively few units whose current expenditures exactly balance their current income; and most units make capital expenditures, which usually involve payments to other units for finished durable goods, materials, or labour, but which may also be internal and imputed (e.g., Crusoe building his boat). Both saving and investment may be calculated gross or net of capital consumption allowances or retirements. Since these diminish saving and investment equally, the difference between saving and investment is the same whether calculated on a gross or net basis.

The relation between saving and investment varies considerably among economic units. For some, saving is regularly in excess of investment. These units, which may be designated as saving surplus units (Chart 3.1), make funds available to the capital market either by acquiring financial assets—money, other claims, or equities—or by reducing their own liabilities through repayment. The fact that a unit has a surplus status does not, of course, mean that it does not have any investment during the period, i.e., that it makes no capital expenditures; it only indicates that the unit's investment is smaller than its saving during the period. For other units, designated as saving deficit units,[2] capital expenditures are in excess of savings. These units absorb funds from the capital market by increasing their liabilities, including the sale of their own equity securities or by reducing their financial assets, including their holdings of money. In the third type of unit, which may be called neutral, saving is equal to investment. These units, therefore, neither supply funds to nor demand funds from the capital market.

If all the economic units in a country were constantly neutral, no capital market would exist and money would be used only as a medium of exchange, as a means of immediate payment for transactions undertaken in markets for commodities and services. Such an economy is characterized by the absence of financial assets or liabilities.

At the other conceptual extreme stands a society in which

[2]The terms surplus and deficit units indicate the difference between saving and investment, not, as might be suggested by the words, the difference between current income and current expenditure which, of course, is equal to saving or dissaving.

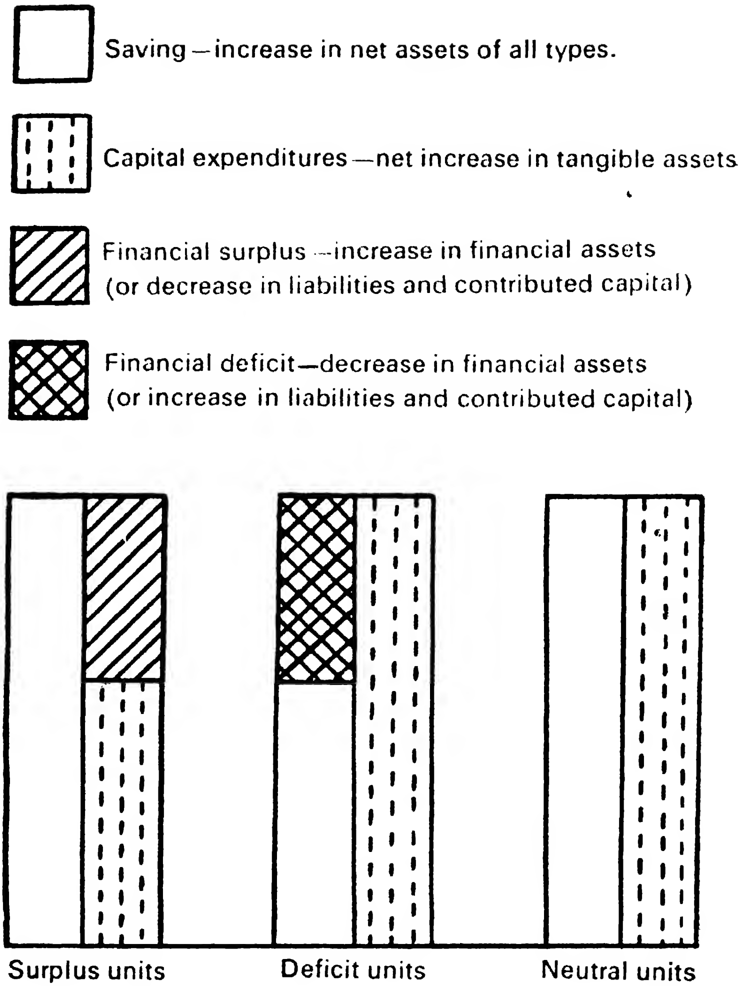

CHART 3.1

Characteristics of Financial Surplus and Deficit Units

saving (or dissaving) and investment are completely separated, i.e., in which the investment of all saving surplus units and the savings of all saving deficit units are zero. Such a society is entirely compatible with the basic characteristics of a modern economy. It would only require that all homes and consumer durables as well as the structures and equipment used by the government and nonprofit organizations, be rented from business enterprises, which in turn rely entirely on external financing supplied by ultimate economic units either directly or through financial institutions.

All the societies which we know and particularly all modern economies, lie between these two extremes. In them, saving surplus units account for most of saving and saving deficit units account for a large proportion of investment. There are well-defined groups that have more or less regularly a saving surplus or deficit status. Within a modern economy, nonfarm households are commonly saving surplus units, while nonfinancial business enterprises and governments as a group generally have a saving deficit status, and financial institutions are close to a neutral position.

This is evident for the United States in Table 3.1, which shows for each of the seven main sectors aggregate saving and aggregate investment, as well as the excess of saving for the period 1946–58 as a whole.

The total saving surpluses and deficits of all sectors together comes to $ 270 billion for 1946–58, as shown in Table 3.1. This figure, to repeat, is not a measure of the volume of primary capital market transactions—i.e., new loans made and new securities issued—because the saving surpluses of some units are netted against the saving deficits of other units within sectors, and because many units simultaneously save and make capital expenditures.

Among the sectors, virtually the only net suppliers of funds are non-farm households, their saving being far in excess of their capital expenditures. This sector's saving surplus is about one-fifth of its gross saving and more than two-fifths of its net saving.

Financial institutions, which hardly make sizeable capital expenditures, represent the only other sector with a saving surplus, but it amounts to less than one-seventh

TABLE 3.1

SAVING AND INVESTMENT, BY SECTOR, 1946–58

(billion dollars)

Sector	*Saving*		*Capital Consumption Allowances*	*Investment*		*Excess Savings: Surplus (+) or Deficit (–)*
	Gross	*Net*		*Gross*	*Net*	
	(1)	(2)	(3)	(4)	(5)	(6)
1. Nonfarm households	680	334	346	554	208	+126
2. Agriculture	89	21	69	95	26	–6
3. Nonfarm unincorp. business	62	12	49	75	26	–13
4. Nonfinancial corporations	278	91	186	359	173	–81
5. State and local govts.	82	29	54	106	52	–24
6. Federal government (civil)	17	1	16	20	4	–3
7. Financial intermediaries	22	19	3	5	2	+17
8. Total (civil)	1,230	506	724	1,215	491	+15
9. Federal government (military)	156	–28	184	156	–28	0
10. Total (including military)	1,386	478	909	1,371	462	+15

Source: *National Balance Sheet*, Vol. II.

Col. 1: Table VIII–d-3.

Col. 2: Table VIII–d–3b.

Col. 3: Difference between gross and net investment.

Col. 4: Table VIII–a–7.

Col. 5: Table VIII–a–7b.

Col. 6: Col. 1 minus col. 4.

Note: Components may not add to totals because of rounding here and elsewhere in this chapter.

of that generated by nonfarm households.

The largest saving deficit is shown by nonfinancial corporations, which alone account for more than three-fifths of the aggregate saving deficits of all sectors. Their saving deficit—which measures the net absorption of funds from other sectors—amounts to three-tenths of their own gross saving but to 90 per cent of their net saving. Unincorporated business, farm and nonfarm, also absorb net funds from other sectors, the saving deficit of these two sectors together being about one-seventh of the saving deficits of all sectors and nearly one-fourth of that of nonfinancial corporations.

State and local governments also show a substantial excess of investment over saving, amounting to more than one-sixth of the net saving deficit of all sectors. The deficit, however, amounts to only about three-tenths of their own gross saving and four-fifths of their net saving, thus being smaller relatively than for nonfinancial corporations but greater than for the other two business sectors.

The federal government had during the postwar period only a negligible excess of investment over saving, so that it neither absorbed funds from other sectors nor supplied funds to them (Chart 3.2).

It is unfortunately impossible to prepare tables similar to Table 3.1 for narrower sectors or to show for any given period the number of saving surplus, saving deficit, and neutral units, and the amounts of aggregate surpluses and deficits. This is because the usual statistics of corporations and governments do not classify units by the existence or size of a saving surplus or deficit. Even households have not been tabulated by the size of their saving surplus or deficit, although the information could be obtained by retabulating the basic data collected in some of the sample surveys of consumer income and expenditure.[3] It is, therefore, impossible to judge how large the average proportion of saving surplus, saving deficit, and neutral units is in the different sectors and subsectors, how it varies with the business

[3]Some inferences can, however, be drawn from average saving and average investment for groups of households classified by total income and expenditures, aggregate saving or dissaving, age and occupation of head of household, or other characteristics by which the data have been tabulated.

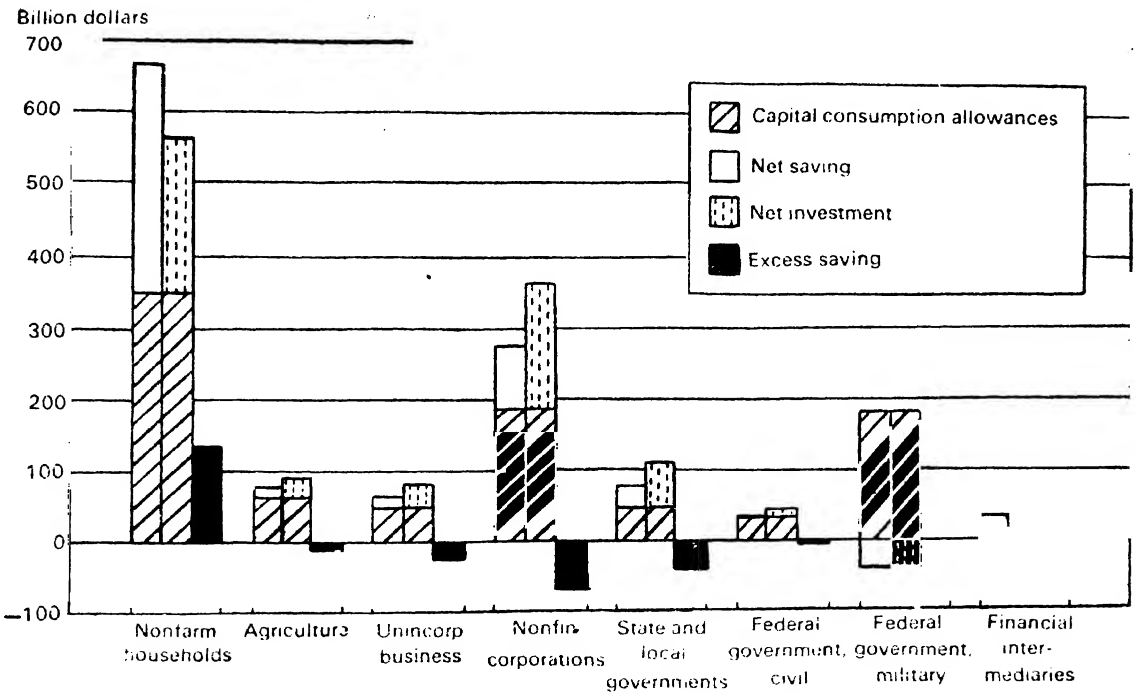

CHART 3.2
Sectoral Saving and Investment 1946-58

cycle, how concentrated surpluses and deficits are within groups, and how regularly the same units show saving surpluses or deficits. This severely reduces our ability to analyze the usual aggregative statistics of savings and investment.

Two Functions of the Capital Market[4]

The capital market of a modern economy has two basic economic functions: first, the allocation of a period's current saving among users and uses, or the supply of financing for the period's investment; second, the facilitation of the transfer of existing assets, tangible and intangible, among individual economic units, groups of them, sectors, and countries. These two functions are closely connected in theory as well as in practice. Modern market economies could not operate without discharging both functions reasonably effectively. In both cases, the main instrument and guide of allocation is the price, in the sense of the yield of a tangible asset or a financial instrument and of yield differentials among assets.[5]

Allocation operates primarily through three devices: first, the pattern of yield differentials among capital market instruments; second, institutional restrictions on the flows of funds which are not expressed in yield differentials—often referred to as capital rationing, i e., the fact that no borrower except possibly the central government can secure any amount of funds by simply offering a higher price; and third, government controls which have effects similar to institutional capital rationing.

Yield differentials reflect primarily three factors: relative cost, relative risk, and relative liquidity. All three factors influence the supplier as well as the user of the funds,

[4]The word 'function' is used here solely to describe an existing situation, not to claim that the allocation resulting from the operation of the capital market is optimal.

[5]The term 'yield' is used instead of the more familiar 'interest rate' in order to emphasize that what influences the allocation of funds is not the nominal interest rate (the relation of the contractual interest payment to the face value of the claim), but the relation of income—fixed or variable; contractual, actual, or expected; gross or net of capital consumption allowances; depending on the situation under study—to the market value of the asset.

but they do so in somewhat different ways.

From the point of view of the lender, it is the relative cost of acquiring a capital market instrument and of servicing it that is relevant. Obviously if it is more expensive for a lender to acquire and administer, directly or indirectly through an agent, one type of capital market instrument than another, then the yield he requires will be higher by the difference in cost, other characteristics of the instruments being equal. This factor explains part of the differential between large and small commitments and between commitments close to or far from the lender's base of operation, although it may not explain the actual size of the differential which, of course, is influenced by many other factors. Even apart from these other factors, the actual yield differential may be larger or smaller than the cost differential unless the market is perfect.

Cost differentials are not constant over time. In particular, costs are likely to be high when a specific capital market instrument is new, is applied to new types of transactions or uses, or is acquired by lenders unfamiliar with it. In other words, in addition to the well-known simultaneous economies of scale, there are historical economies of habituation which are independent of, or complementary to, economies of scale.

In a perfect market where participants act rationally and take the long view, the risk component in interest rate differentials would be equal to the expected average loss on a specific type of commitment.[6] Loss here is to be interpreted broadly, including not only ultimate out of pocket cost after tax, but also making allowance for the cost of liquidating the commitment, the foregone opportunities of using the funds otherwise, the loss of actual or potential business because of adverse publicity connected with losses, even if covered by reserves, and similar indirect effects of commitments that get into difficulties. Hence an entirely rational risk allowance by the lender may well be above the strictly actuarial evaluation of losses. If participants do not act rationally and do not take the long view, in which reserves established on some commitments are regarded

[6]To the extent that repayment provisions reduce this risk, e.g., by providing for gradual repayment or callability at the borrower's choice, they improve an instrument's liquidity and may reduce its yield.

as balancing losses of other commitments, the risk allowance reflected in yield differentials is indefinite and erratic.

Even if they try to act rationally, different lenders will differ in their evaluation of the risk inherent in the same commitment, particularly of the nonactuarial component of risk. So much has been written recently about different attitude toward risk that it does not seem necessary to elaborate on this point. These differences in the evaluation of the risk on identical commitments would drive the risk component in yield differentials up to the risk allowance of the lender who rates the risk highest and who is still needed to satisfy demand.

SCOPE OF THE CAPITAL MARKET

In this report the broadest and simplest limitation of the boundaries of the capital market will be used. It will cover all financial assets and liabilities and all transactions in such assets except those which involve the exchange of money for a nonfinancial consideration, i.e., except monetary payments in exchange for commodities and for labour and capital services. For statistical convenience, gross transactions in money and money maket instruments (federal funds, Treasury bills, bankers' acceptances, commercial and finance company paper), though not the holdings or net changes in them, will be disregarded.

The capital market so defined includes transactions not only in organized markets—securities exchanges or the over-the-counter markets—but also in nonmonetary financial assets effected among financial institutions, between a financial institution and a member of another sector of the economy, or among members of nonfinancial sectors. The capital market also covers imputed transactions of a financial character, the most important of which are retained earnings (internal saving), accruals and capital consumption allowances, and interest accrued. These are sometimes called non-market capital fund flows to distinguish them from actual capital market transactions.

This definition of the capital market entirely ignores the distinction often made between the capital market and the money market, i.e., the separation of liquid short-term claims and liabilities from other financial assets. There seems to be

no sound reason for making this distinction as no sharp boundary exists between short-term claims, on the one hand, and long-term claims and equities, on the other. Instead, a fairly continuous spectrum extends from claims that can be immediately exchanged for cash—whether legally or actually—to claims with a very distant, or even without any final, maturity. There is more economic meaning in the distinction between financial assets which are a general medium of exchange—i.e., the U.S. currency and deposits with the Federal Reserve or commercial banks subject to check—held outside the banking system and other financial assets. Under this distinction, however, the scope of the 'money market' becomes small in comparison to the capital market and little reason remains for the separation, particularly in view of the existence of financial assets of near-money character.

CAPITAL MARKET INSTRUMENTS

The capital market has two aspects—flows of financial transactions and stocks of financial assets and liabilities—which are closely related because stocks may be looked upon as the sum of net previous flows and net flows can be regarded as first differences in stocks.[7]

There are as many categories of financial flows as there are types of financial instruments, i.e., types of intangible assets and liabilities that are reasonably homogeneous internally and distinguishable from each other. Within financial stocks and flows, the basic distinction is between claims, which are expressed in terms of a definite number of monetary units and usually carry a fixed interest rate, and equities which embody fractional right to profits (i.e., certain residuals between income and expenditures or between assets and liabilities) and which fluctuate in value. Among claims, in turn, at least five main categories can usefully be distinguished, despite gradual transitions between them: money, nonmonetary short-term claims against financial institutions, other short-term claims, long-term claims against financial institutions, and other long-term claims.

[7]This is a simplified formulation which disregards difficulties introduced by valuation changes.

Each of these categories, as well as equities, can be further divided according to their marketability under normal conditions. This leads to the establishment of nine chief categories of financial assets and the corresponding types of financial transactions, which are shown in Table 3.2 together with rough estimates of their size in 1958 in the United States to indicate orders of magnitude. For practical purposes, a finer and somewhat different breakdown of financial assets is needed, one which will vary with time and place and will be strongly influenced by the prevailing legal and institutional arrangements.

TABLE 3.2

MAIN CAPITAL MARKET INVESTMENTS, 1958

	Order of Magnitude (billion dollars)	*Per cent of Total*
(1)	(2)	(3)
1. Money (monetary metals, currency, checking deposits)	222	11
2. Nonmonetary short-term claims against, financial institutions	150	7
3. Other marketable short-term claims (Treasury securities with maturity of less than one year, commercial paper)	69	3
4. Other nonmarketable short-term claims (bank loans, loans on securities, other loans, trade receivables, consumers receivables, other intangible assets)	295	14
5. Marketable long-term claims (marketable Treasury securities with maturity of more than one year, state and local government securities, publicly offered corporate bonds)	223*	11
6. Nonmarketable long-term claims against financial institutions (represented by assets of life insurance companies and private and government pension funds)	200	10
7. Other nonmarketable long-term claims (other U.S. government securities, other bonds, mortgages, bank term loans, investments in rest of world)	351*	17

(1)	(2)	(3)
8. Marketable equities (corporate stock including corporate stock listed on exchanges or actively traded in over-the-counter markets)	372	18
9. Nonmarketable equities (equities in financial nonprofit organizations and in unincorporated nonfarm business, other corporate stock)	200	10
10. All financial assets	2,082	100

Source: All table references below are to *National Balance Sheet*, Vol. II, unless otherwise specified.

Line 1: Table I, line II–1.
Line 2: Table I, line II–2.
Line 3: Table I, line II–13a, and Table III–51–a, col. 1.
Line 4: Short-term bank loans are from Table I, line II–9, minus bank term loans (Table IV–c–9b) and Table III–51–a, sum of cols. 3, 7, and 10 (commercial paper held by banks). Other items are from Table I, lines II–6, 7, 8 and 10, and Table IV–b–20, line 11.
Line 5: U.S. government securities are from *Treasury Bulletin*, February, 1959, p. 25, minus Table I, line II-13a. State and local government securities from Table I, line II-14. Publicly offered corporate bonds represent 60 per cent of other bonds and notes (Table I, line II–15) minus other commercial paper (Table III-51-a, sum of cols. 4, 8 and 11).
Line 6: Table I, lines II-3, 4 and 5.
Line 7: U.S. government securities are from Table I, line II-13, minus Table I, line II–13a, and U.S. government securities included in line 5. Other bonds are 40 per cent of other bonds and notes (Table I, line II-15) minus other commercial paper (Table III-51-a, sum of cols. 4, 8 and 11). Mortgages are from Table I, lines II-11 and 12. Bank term loans are from Table IV-c-9b. Investments in rest of world are from Table IV-b-20, lines 9 and 10.
Line 8: *25th Annual Report*, SEC, pp. 62 and 67.
Line 9: The sum of equities in other business (Table I, lines II-18 and II-19), corporate stock (Table I, lines II-16 and II-17) minus marketable corporate stock (line 8 of this table).

*If government-insured mortgages were considered marketable long-term claims, line 5 would equal $278 billion and line 7 (excluding government-insured mortgage) would equal $296 billion, since FHA- and VA-insured mortgages equal $55 billion (Tables IV-b-11a-6 and IV-b-11a-4).

CAPITAL MARKET PARTICIPANTS

Three basically different groups must be distinguished among the owners and issuers of financial instruments and among the partners to the transactions of financial assets: financial institutions, nonfinancial business enterprises, and ultimate economic units (i.e., households and governments). Financial institutions are those whose assets are predominantly financial (i.e., claims against other sectors and equities of other business enterprises not their own subsidiaries and affiliates), and whose liabilities are in general regarded as liquid assets by the creditors, predominantly nonfinancial business enterprises and households. Ultimate economic units are distinguished from both financial institutions and nonfinancial business enterprises in that their net worth cannot under present legal arrangements become the property of another economic unit as does that of business enterprises.

In a modern economy financial institutions hold a considerable proportion of all financial assets outstanding, even excluding claims against other financial institutions. In the United States the share of financial institutions in such financial assets (chiefly business and consumer loans, mortgages, and securities) is now of the order of two-fifths.[8] At the same time the liabilities of financial institutions constitute a large proportion of the financial assets and a substantial share of the total assets of nonfinancial business enterprises as well as of households and governments. These relationships are illustrated in Chart 3.3 for the end of 1958.

Chart 3.3 shows that claims against financial institutions represent three-tenths of the total assets of households and account for almost one-half of nonfarm household financial assets. At the same time liabilities to financial institutions represent nine-tenths of all nonfarm household debt. The link to financial institutions is less pronounced in business enterprises (including farm business). Claims against financial

[8]Raymond W. Goldsmith, Robert E. Lipsey, and Morris Mendelson, *Studies in the National Balance Sheet of the United States*, Vol. II: *Basic Data on Balance Sheets and Fund Flows*, Princeton for NBER, 1963. Table I (1958).

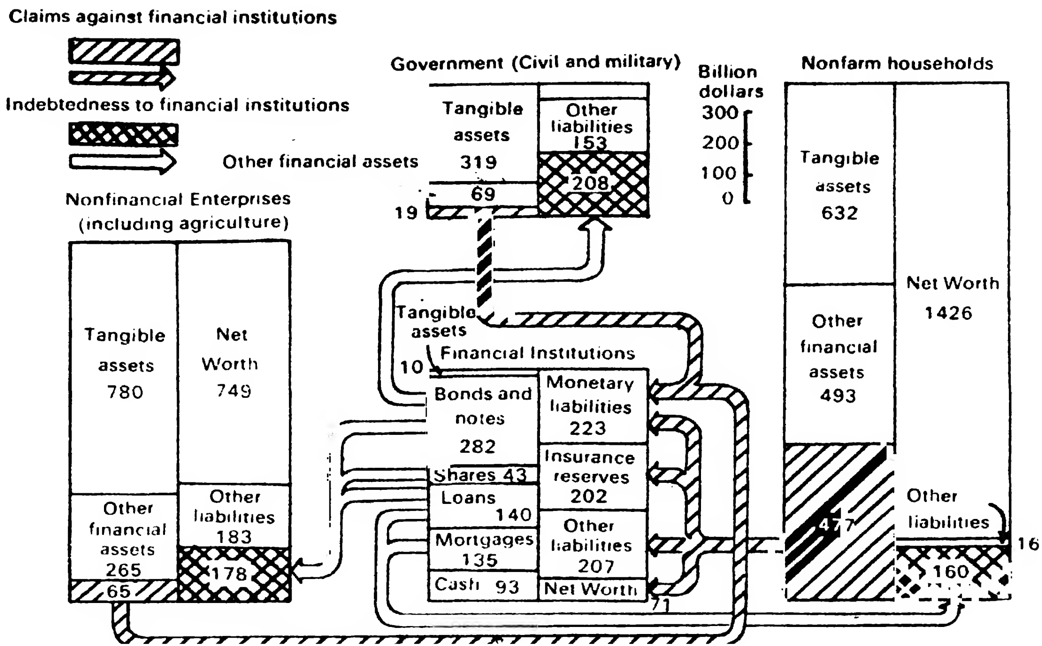

CHART 3 3

Balance Sheet relations between financial institutions and non-financial Sectors, 195 '. For sources and notes see pp. 39-40.

NOTES TO CHART 3.3

Source: *National Balance Sheet*, Vol. II, Table I, 1958; and, for federal government, also Table III–7a. The following detailed explanation refers to the columns and lines in Table I, 1958, unless otherwise specified.

Nonfarm Households

Net worth: Col. 1, line IV.

Other liabilities: Col. 1, line III–14, less indebtedness to financial institutions.

Indebtedness to financial institutions: Sum of col. 1, lines III–8, III–9, III–10, and col. 5, lines II–6 through II–11a.

Tangible assets: Col. 1, line 1–7.

Other financial assets: Col. 1, line II–21, less claims against financial institutions.

Claims against financial institutions: Sum of col. 1, lines II–1, II–2, II–3, II-4, II–5, II–10, and II–18, and col. 5, line IV.

Nonfinancial Enterprises

Net worth: Cols. 2, 3, and 4, line IV, less col. 5, lines II–16 and II–17. (Lines II–16 and II–17 of col. 5 are treated as indebtedness of nonfinancial corporations to financial institutions.)

Other liabilities: Cols, 2, 3, and 4, line V, less net worth and indebtedness to financial institutions.

Indebtedness to financial Institutions: Sum of col. 5. line II–7; cols. 2, 3, and 4, line III-9; a quarter of col. 5, line II–10; col 5, line II–11b and II–12; col. 5, line II–15 less line III–12, and col. 5, lines II–16 and II–17.

Tangible assets: Cols. 2, 3, and 4, line 1–7.

Other financial assets: Cols. 2, 3, and 4, line II–21, less claims against financial institutions.

Claims against financial institutions: Cols. 2, 3, and 4, lines II–1, II–2, and II–3.

Financial Institutions

Net worth: Col. 5, line IV.

Monetary liabilities: Col. 5, line III–1.

Other liabilities: Col. 5, line III–14, less monetary liabilities and insurance reserves.

Insurance reserves: Col. 5, lines III–3, III–4 and III–5.

Tangible assets: Col. 5, line 1–7.

Shares: Col. 5, lines II–16 and II–17.

Bonds and notes: Col. 5, lines II–13, II–14, and II–15.

Mortgages: Col. 5, lines II–11 and II–12.

Loans: Col. 5, line II–21, lesss shares, bonds and notes, mortgages, and cash.

Cash: Col. 5, line II–1.

Government

Net worth: Sum of col. 6, line IV, and Table III–7a, line IV.

Other liabilities: Cols. 6 and 7, line III–14, less indebtedness to financial iustitutions.

Indebtedness to financial institutions: Sum of col. 7, line III-9, and col. 5, lines II–13 and II–14.

Tangible assets: Sum of col. 6, line I–7, and Table III–7a, line I–7.

Other financial assets: Cols. 6 and 7, line II-21, less claims against financial institutions.

Claims against financial institutions: Cols. 6 and 7, lines II–1 and II–2.

institutions constitute about one-fifth of financial assets and about 6 per cent of total assets, while liabilities to financial institutions (including bonds and stocks held by financial institutions) represent about one-half of the total debt of nonfinancial enterprises, and financial institutions hold one-twentieth of their equity. In the case of federal, state, and local governments, claims against financial institutions are relatively unimportant, accounting for one-fifth of financial and about 5 per cent of total assets.

Financial institutions thus are of particular importance among capital market participants. A summary picture of the main types of financial institutions operating in the United States in 1958 is, therefore, given in Table 3.3.

At that time all financial institutions, broadly defined, had $800 billion of assets, which was more than one-fifth of the total national assets, i.e , the aggregate of the assets of all independent economic units in the United States. Use of the narrower definition, which is employed in most of this report and excludes personal trust funds and a few other minor types of financial institutions, reduces the amount and the share to slightly below one-fifth. Since the assets of financial institutions consist primarily of claims, their share in these is, of course,

TABLE 3.3

SYNOPSIS OF FINANCIAL INSTITUTIONS, 1958 AND 1945

	Type of Institution	Total Assets 1958 (billion dollars)	Total Assets 1945 (billion dollars)	Annual Rate of Growth (per cent)
		(1)	(2)	(3)
1.	Monetary authorities	79.2	69.8	1.0
2.	Commercial banks	241.3	160.4	3.2
	Demand deposit business	167.7	128.0	2.1
	Time and saving deposit business	73.6	32.4	6.5
3.	Mutual saving banks	38.1	17.0	6.4
4.	Savings and loan associations	55.4	8.8	15.2
5.	Credit unions	4.4	0.4	20.0
6.	Life insurance organizations	111 6	46.6	7.0
	Companies	108 8	44.9	7.0
	Fraternal orders	2.8	1.7	3.9
7.	Private pension funds	27.8	2.7	19.7
8.	Govt. insur. and pension funds	66.1	25.8	7.5
	Federal	49.9	22.8	6.2
	State and local	16.2	3.0	13.9
9.	Fire and casualty insurance	25.6	7.6	9.8
10.	Investment companies	20.4	3.6	14.3
11.	Finance companies*	20.8	2.0	19.7
12.	Security brokers and dealers	6.3	5.0	1.8
13.	Govt. lending agencies	29.9	18.4	3.8
14.	Personal trust departments	55.4	29.0	5 1
15.	Miscellaneous finance†	6.6	2.5	7.8
16.	Total	788.9	399.6	5.4

Source: *National Balance Sheet.* Vol. II, Tables III–5a through III–5m, III–1a, and III–7c.

*Includes mortgage companies.

†Includes banks in possessions, agencies of foreign banks, agricultural credit organizations, group health insurance, and savings bank life insurance.

considerably higher. It amounted in 1958 to about one-third of the national total for short-term claims and to half of all long-term claims. In contrast, financial institutions held only one-tenth of corporate stock outstanding and less than 1 per cent of tangible assets.

As a comparison of columns 1 and 2 in Table 3.3 shows, the assets of financial institutions grew rapidly during the postwar period, nearly doubling. This increase is in line with the expansion of gross national product during the postwar period, but is somewhat smaller than the rise in the market value of national assets. The relative size of financial institutions in 1958 thus was equal to or, in comparison to national assets, slightly below the level of 1945. It was, however, throughout the postwar period above the predepression level.[9]

The doubling of the assets of all financial institutions resulted from considerable differences in growth among the main types of institutions. On the one hand, money-issuing institutions, i.e., the Federal Reserve System and the demand deposit departments of commercial banks, increased their assets only by one-fourth between the end of World War II and 1958. All other financial institutions together expanded their assets by 170 per cent, or even by 180 per cent if personal trust funds are excluded. Among these other financial institutions, two groups need to be distinguished. Growth was relatively moderate, amounting to between 115 and 140 per cent over the postwar period, for the saving departments of commercial banks, mutual savings banks, life insurance companies, and federal insurance and pension funds. At the other extreme, savings and loan associations, investment companies, and state and local government insurance and pension funds increased their assets by from 400 to over 500 per cent. Trusteed private pension funds, credit unions, and finance companies were even able to expand their assets tenfold. Some of these differences reflect stagnation or shrinkage during World War II, for instance, in the case of finance companies and savings and loan associations. Other institutions may be regarded as still being in the early phases of development during which the rate of growth is usually considerably more rapid than among old established institutions.

[9]For a comparison of the share of financial institutions in national assets since the turn of the century, see my *Financial Intermediaries in the American Economy Since 1900*, Princeton for NBER, 1958, Chapter IX, e.g., Table 95, p. 319.

4

Finance*

Joan Robinson

This essay explains how the supply of saving is related to the supply of finance and investment. The author shows that the amount of finance available in a particular situation is not governed by the rate of saving going on at that moment and that it is perfectly possible for schemes of finance to be arranged on a single day which would keep investment and saving running high for years. While finance required for a particular scheme has to be arranged before *the actual investment outlay takes place, the savings which correspond to it are made only* after *the income generated by it has worked its way through the economy. Hence the connection between saving and finance is of a round-about nature. The other factors which influence the supply of finance to business firms are: the distribution of saving between entrepreneurs on the one hand and others (rentiers) on the other, the state of expectations, and the legal and institutional arrangements regarding finance*

Editor

There is another kind of check upon the possible rate of accumulation besides capacity and available labour: that is,

*Taken from Joan Robinson, *The Rate of Interest and Other Essays*, Macmillan & Co. Ltd., London, 1952, pp. 80–87. Reprinted by permission of the author.

the supply of finance. A world in which entrepreneurs could borrow without limit at the ruling rate of interest, would be much unlike the world we live in. Unlimited borrowing would be possible only where there was no uncertainty about future profits, not only in the broad, but in respect to the fortunes of individual enterprises. Where there is uncertainty, borrowers must provide lenders with more security than their own hopes, and investment plans are limited by the supply of finance.

Owing to the ambiguous nature of the word *capital* there is a tendency to confuse the supply of finance with the supply of saving.[1] But they must be sharply distinguished, for they operate on totally different planes. A 'shortage of capital', in the sense that saving is inadequate, limits the rate of investment which it is physically possible to carry out; it shows itself in an excess of demand for labour over supply, and it is caused by a higher proportion of consumption to income. A 'shortage of capital', in the sense of an inadequate supply of finance, limits the investment plans which entrepreneurs are able to organise. It shows itself in a high risk premium on industrial securities and in difficulty in arranging new loans, and it may be caused by general lack of confidence on the part of owners of wealth, or by the fact that too small a part of total wealth is owned by actual or potential entrepreneurs.

It is true that the amount of finance (including investment of a firm's own funds) actually used during a period is equal to the savings made during the period. because both are equal to the investment made during the period, but there is no direct connection between them. In respect to a particular scheme of investment, the finance which it requires has to be arranged before outlay on investment begins,[2] while the purchase of securities out of the savings which correspond to it

[1]See Robertson, *Essays in Monetary Theory* [32], p. 3.

[2]The entrepreneur, to save interest payments, as far as possible avoids borrowing in advance of actual outlay. He prefers to arrange for a 'line of credit' (in the simplest case, overdraft facilities at a bank). As the actual outlay on investment is made the credit is used up, the lender providing the borrower with funds by selling out other assets, and accepting his obligations in their place. Thus finance is not normally taken until actual outlay is made, but it must be provided for in advance when the scheme of investment is planned.

are made only after the income which it generates has worked its way through the economy. Nor is the amount of finance available in a particular situation in any way governed by the rate of saving which is going on at that moment. It is perfectly possible for schemes of finance to be arranged on a single day which would keep investment (and saving) running at the maximum possible level for years. On the other hand the existence of idle resources, which indicates that potential saving is running to waste, does nothing to facilitate the supply of finance.[3]

All the same there is an important round-about connection between saving and finance. This is seen most clearly if we go to the opposite extreme from the assumption of unlimited credit and, instead of assuming that every entrepreneur can borrow *ad libitum*, assume that there is no borrowing at all, and that each entrepreneur is confined to investing his own past accumulated savings, so that the only source of funds for investment is 'internal finance'.[4] Even then, each does not make new investment crumb by crumb as profits accrue. In any one year some are investing and some accumulating reserves by saving out of profits. Each scheme of investment, paid for from reserves, so to speak uses up finance equal to its value. By the time the investment has been completed and expenditure out of incomes earned in making the investment has run its course, savings equal to the value of the investment have been added to wealth somewhere in the economy.

Now, from the point of view of any individual concern, the investment which it will plan to undertake in any situation, depends upon two things—prospective profits and the amount of reserves at its disposal. Its reserves in turn depend upon the savings which it has made in the more or less recent past.

[3]Except in so far as the authorities deliberately make credit easy in an attempt to help recovery.

[4]We must suppose that the entrepreneurs are sufficiently versatile to make investments wherever the prospect of profit is greatest, for, if each invests only in the line of business where he happened to start, production would rapidly get out of step with demand (unless demand in each line happened to expand in just the right proportions) and the prospect of profit in some lines would fall so low that investment in them would cease.

If other members of the community besides entrepreneurs are saving, the addition to reserves of firms made in any period is less than the investment carried out in that period, and the system must soon run down.

But even if all saving were done by entrepreneurs, the system is not guaranteed against trouble, for the distribution of saving between firms may have an influence on the course of investment. Suppose, for instance, that there are some young and enterprising firms, and some old and cautious ones. The young firms commit whatever reserves they may have to investment. A large part of the corresponding savings are made by the old firms. Thus the ownership of uncommitted reserves gradually changes hands. The young firms would like to continue investment, but soon they have no more funds. The old firms have the funds but hesitate to commit them. The rate of investment therefore fails to be maintained, and the system runs down.

Thus not the amount, but the distribution, of saving in one period has an influence upon the course of investment in the next.[5]

We must now remove the assumption that all investment is financed from reserves and introduce rentiers into the picture. The finance to match investment plans is not limited to uncommitted reserves of firms, but can be extended indefinitely by borrowing.[6] The investment plans which can be organised now depend very much upon the distribution of the ownership

[5]Marx assumes that reserves amassed in one period will always be invested in the next (except in times of crisis). In this case the rate of accumulation is governed by saving, though the mechanism is totally different from that postulated by the monetary theory discussed above.

[6]In the case where each piece of investment is financed by the past savings of the firm which makes it we can speak of the supply of finance in existence at any moment—that is, the sum of uncommitted reserves of firms. When borrowing is possible the supply of potential finance cannot be so definitely conceived. It depends very much upon the credit of would-be borrowers. Moreover the amount that any one can arrange to borrow, at a particular moment, increases up to a certain point with the interest that he offers, though it does not increase indefinitely, since it is of no use to try to attract finance by offering a rate of interest that no one believes the borrower will be able to honour. (See Kalecki, 'The Principle of Increasing Risk', *Essays in Economic Fluctuations* [16].)

of wealth. There is an element of the pawnshop in even the most sophisticated kind of borrowing—existing wealth is pledged as a guarantee for new loans. Thus (given the prospects of profit and the general state of confidence and the reputation of the particular concern) the amount of new borrowing that an entrepreneur can arrange at any moment largely depends upon the ratio of the total debt of the concern to its total assets, that is, on the proportion of its assets that it owns outright. (If the debt of a concern is say, half the value of its assets, net earnings, reckoned as a percentage on the value of the assets, can fall to half the rate of interest on the debt before the concern defaults or begins to pay interest out of capital.)[7]

Suppose that we start from a position with a given number of entrepreneurs, each of whom owns half the capital which he operates. If each continually makes net saving (in excess of amortisation) at a rate equal to half the investment which he carries out, the ratio of debt to assets remains unchanged (apart from accidental gains and losses) and the supply of finance (so long as prospects and confidence remain constant) will be continually renewed as it is used up.

If more than half of all saving is done outside the concerns, say by rentiers, then the ratio of debts to assets in the concerns is rising, and the power of the original set of entrepreneurs to borrow is gradually exhausted. All the same, investment can continue indefinitely if the class of entrepreneurs is recruited, at an adequate rate, by rentiers using their accumulated wealth to start businesses. (Rentiers may prefer land to industrial securities, so that there is a tendency for the yield on real property to fall continuously, relatively to the yield on industrial securities, but this tendency is held in check if from time to time a landlord sells his estate and sets up in business, or dissipates his wealth in riotous living, thus swelling the savings of entrepreneurs by the amount of his dissaving.) Alternatively, banks may step in, and borrow from the rentiers—

[7]See Kalecki [16], p. 99. Mr. Kalecki works out his argument as though new borrowing was governed by the absolute difference between the capital owned by the firm and its 'commitments' but he states in a footnote that it is the ratio, not the difference, which is relevant.

that is, accept deposits from them—in order to take a share in business.

On the other hand, if the net saving of the entrepreneurs that we start with bears a higher ratio to their borrowing than their initial capital to their initial debt (that is, in our example, if their rate of saving is equal to more than half of their rate of investment) the proportion of debt to assets is constantly falling, and the supply of finance to them is growing continually easier.[8] (There may then be a continuous leakage as business fortunes are invested in land, without the supply of finance to industry drying up.)

Thus we find once more that the distribution of saving (though not its amount) has in the long run a cumulative influence upon the supply of finance, and so, indirectly, upon the rate of investment.

The price at which finance can be obtained is related to the yield at ruling market prices on securities comparable with those to be issued by way of the new loans; this depends on the total supply of such securities outstanding, in relation to the demand for them, the demand being influenced by the tastes and views of owners of wealth and the supply of other

[8]The ease with which a firm can command finance is not the same thing as its liquidity. When the proportion of its own capital to its total debt is high, the firm is in a favourable position to finance new investment, even if all its capital is already sunk in the business, so that it has no loose funds of its own. Quite apart from this there are the reserves which it has accumulated by saving and which at a particular moment are not yet committed. These provide 'internal finance'. A firm will generally be more ready to finance its own investment than outsiders are to finance it. It charges itself, so to speak, a lower risk premium than it would have to pay for outside funds. Thus the existence of a large amount of internal finance promotes investment. This is different again from liquidity in the sense of holding cash. It may happen, over a period when a budget deficit is running, that the savings of firms (together with any borrowing they have made) exceed industrial investment, so that industry as a whole at the end of the period is highly 'liquid' in the sense of commanding a large amount of 'internal finance', but it need not be 'liquid' in the sense of holding a large cash balance. The motive for holding reserves in cash is fear that the rate of interest may be higher (and the value of securities lower) when the funds come to be used than it is at present. The amount of a firm's cash balance are not an indication of its 'liquidity' in the sense of commanding internal finance, but of its liquidity preference in Keynes' sense.

assets, and by the supply of money relatively to the needs of active circulation, in the manner sketched above. A fall in the general level of interest rates tends to lower the price required for new finance (because it reduces the return which the lender can get on his money in other ways) and to increase the amount of finance available on given terms.

Further influences upon the supply of finance may be summed up under two broad headings; first, the state of expectations, and, second legal and institutional arrangements and the habits of lenders. There is a general tendency for the supply of finance to move with the demand for it. It is true, of course, that at any moment there are many excellent ideas which cannot be implemented because those who have conceived them are unable to back them with finance. But, by and large, it seems to be the case that where enterprise leads finance follows. The same impulses within an economy which set enterprise on foot make owners of wealth venturesome, and when a strong impulse to invest is fettered by lack of finance devices are invented to release it (the invention of the joint-stock company was a technical revolution comparable to the invention of the steam-engine), and habits and institutions are developed accordingly (it was possible for the prejudice against banks participating in industry to take root in England, where other sources of finance were forthcoming, but not in Germany, where they were not). On the other hand, in a stagnant economy it is impossible to say whether it is lack of enterprise or lack of finance which prevents development from getting under way.

What is true of the broad sweep of development is also true from year to year in a given economy. A high level of prospective profits and a high degree of confidence in these prospects promote enterprise and at the same time ease the supply of finance. A fall in confidence restricts the supply of finance at the same time as it checks the desire to invest. Thus the supply of finance cannot be regarded as a rigid bottleneck limiting the rate of investment, but must be treated rather as an element in the general atmosphere encouraging or retarding accumulation.

5

Rudimentary Finance*

John G. Gurley and Edward S. Shaw

This essay shows that an efficient dispersion of saving among investment opportunities, and thereby the rate of growth of output, is dependent upon the efficacy of the financial system. The basic task of the financial system is to stimulate saving and to allocate it to efficient uses. An immature financial system places severe financial restraints on real growth which can be speeded up by removing the financial constraints. The paper uses the setting of a rudimentary economy to underline the role and importance of financial assets in economic growth. The authors make an important contribution to our understanding of the financial system by unifying the theory of money (which is just one of the many kinds of financial assets) with that of finance.

Editor

Financial Restraints on Real Growth

It is difficult to attain a satisfactory rate of growth in real output. Such a growth rate may not be achieved for a number of reasons, some social, some psychological, some political,

*Taken from John G. Gurley and Edward S. Shaw, *Money in a Theory of Finance,* The Brookings Institution, Washington, 1960, pp. 46-53.

and some economic. What is significant here is that the rudimentary economy places severe financial restraints on growth of real output. An immature financial system is in itself an obstacle to economic progress. In this section we consider ways in which limitations on lending and borrowing hamper real growth in the rudimentary economy.

The output that an economy is capable of producing depends on the input of labour services and on the size of the capital stock, given the state of the productive arts. Labour services aside, net output capacity expands as the capital stock increases—as there are saving and investment. However, net output capacity depends only partly on the level of investment. It depends also on the efficient allocation of investment among alternative capital projects.

The design and performance of a financial system may stimulate saving and investment in efficient uses or it may retard saving and divert it to inefficient uses. The financial system in our rudimentary economy does not pass with a high score on these counts. Especially in a regime of private enterprise, it is not congenial to a rapid growth of real output.

RESTRAINT ON THE LEVEL OF INVESTMENT

If capital is to accumulate in the rudimentary economy, there must be domestic saving to finance it, since no borrowing is permitted from abroad. The domestic saving must come from the private sector, since government has no income. Within the private sector, there is consumer saving only for accumulation of real money balances and, even then, only as consumer demand for real balances is satisfied by issue of nominal money rather than by price deflation. Such consumer saving, along with any business saving also directed to increases in real money balances, necessarily flows to the government sector for its disposition. Only business saving not allocated to real money balances is available for private investment. If government were to incur its deficits on transfer payments to business, rather than on spending for goods and services, all saving could flow to private capital formation. If the model were relaxed a bit, so that firms might dishoard their money balances to satisfy consumer demand for money, there would be a direct route

for the flow of consumer saving to business. However, economies in money balances of business could hardly be very significant before the implicit deposit rate on these balances would rise enough relative to the rental rate on capital goods to inhibit further transfers.

The financial system of the rudimentary economy offers to private spending units just one kind of financial asset, money, as an enticement to saving. It provides business with no financial instrument of its own to issue as an inducement to saving by consumers, and government is not allowed to issue nonmonetary debt. The financial system makes no attempt to stimulate private saving either by offering different kinds of financial assets or by allowing an explicit rate of interest on financial assets. As a result, we must suppose, the propensity to save and the rate of growth in capital will be relatively low, given the distribution of income between consumers and firms.

RESTRAINT ON FLOW OF SAVING TO INVESTMENT

The financial system of the rudimentary economy provides two channels for the flow of saving to investment in capital goods. Each firm directs its own saving to its own investment projects to the extent that its saving exceeds its incremental demand for money. And all saving, both by consumers and firms, that is allocated to accumulation of real money balances flows to government. If incremental demand for money is satisfied by price deflation, saving flows to investment in tangible assets only through the first channel. If prices and money wage rates fall by less than is required to satisfy incremental demand for money, governmental issues of nominal money draw saving through the second channel for such allocations as government policy specifies. Government has various options in its deficit-spending: it may invest the flow of private saving in social capital; it may finance private investment through transfer payments; or it may spend in ways that do not increase the stock of capital goods.

This financial regime evidently puts heavy responsibility on the government sector for investment planning. First, the

rate of private saving depends on monetary policy regarding the price level. Second, allocation of private saving for accumulation of money is more or less efficient according to the government's selection of investment projects.

Private enterprise in allocation of saving to investment is minimized in the rudimentary economy. Consumers may direct their saving only to the government sector. And each firm has access, except through government transfer payments, only to its saving. If government were to permit incremental demand for money to be satisfied only by price deflation, the economy would have no specialization in saving and investment. There would be no markets where firms could compete for private saving, where investment opportunities could be ranked according to their marginal efficiencies, and where price in the form of the bond rate of interest could disqualify the less efficient projects. There would be no private mechanism for merging the saved income of numerous spending units to finance investment on the large scale. Private security issues and markets for disposing of them to savers are indispensable to private enterprise in accumulation and allocation of capital.

SAVING, INVESTMENT AND MONEY

The financial system of the rudimentary economy is inefficient since it provides neither the array of financial assets that would stimulate saving nor the array of financial markets that would allocate saving competitively to investment. But it is clearly better than no financial system at all, because it does provide one financial asset—money.

The existence of money as a financial asset gives each spending unit the opportunity to spend more or less than its income. It opens the way to borrowing and lending. Since the spending unit with income to spend is not necessarily the spending unit with the most rewarding opportunities to spend, lending by savers and borrowing by investors permits a more efficient allocation of spending to output in our economy than presumably would be feasible in a still more primitive society. Any financial asset permits the reallocation of income among spenders and allows some potential spenders to pit their spending options against others. The trouble with the

rudimentary economy is that it provides only one financial asset and does not fully exploit financial incentives to saving and financial media for efficient dispersion of saving among investment opportunities.

INNOVATIONS IN FINANCE

A financial system restrains growth if it ties the distribution of spending too rigidly to the distribution of income and if it does not make institutional provision for selective matching of surplus budgets in some sectors with deficit budgets in others. Spending units can be expected to look for ways around such restraints. Indeed, in any economy, the financial structure is continually reshaped by the efforts of spending units to break out of the confines of existing financial arrangements.

In the remainder of this chapter, we consider briefly some of the simpler financial devices that have been used in relatively underdeveloped economies to expedite the flow of saving between spending units. Any one of them might be grafted to our rudimentary economy to raise its rate of real growth.

ELEMENTARY FINANCIAL EXPEDIENTS

The early economic history of the United States offers interesting illustrations of ways to ease financial restraint on real development. The formation of partnerships was a common device for mobilizing saving in the American colonies before the emergence of corporate organization and of private markets in corporate securities. The merging of business budgets by partnership arrangements widened the range of investment opportunities for any given dollar of saving. The pooling of consumer saving in mutual societies also lowered barriers to the flow of funds into relatively urgent uses.

Another popular technique for raising funds in colonial times was the lottery, which has a long tradition the world over as a substitute for private security issues. If the value of prizes is set well below the value of lottery tickets sold, the game obviously can be played to the advantage of its operator. And the operator may spend his winnings on investment. The colonial governments used lotteries not only to gain funds for

themselves but also to extend grants to private individuals and business firms. The colonies—and the states, too, later on—also permitted individuals to conduct lotteries to finance designated investments. The lottery ticket may not be a perfect substitute for a bond or stock certificate, but in many countries it has been one of the first steps along the road of financial development.

Government has tapped private saving by money-issue, by lottery, by taxation, by sale of goods produced under government auspices, by direct appropriation of private output, and by sale of monopoly charters or religious privileges. It has applied saving from such sources to its own investment projects or it has released command over saved resources to private enterprise through numerous techniques of transfer payment. In our own colonies, these transfer techniques included bounties to encourage investment in preferred categories, premiums for output of exceptional quality, and subsidies for desired enterprise that was slow to gain momentum.

All governments, in societies both primitive and advanced, have exploited private real demand for money, in the manner of government in our model. They have invented devices, too numerous for listing here, to stimulate real demand for money at given levels of output and income in the community. Money was early made receivable for taxes in this country and elsewhere, and usually receivable as legal tender for payment of debts, with penalties provided for creditors who preferred other means of settlement. In physical appearance, in denomination, in provisions for convertibility, and in other ways, efforts were made to increase real demand for money. Primitive price controls and rationing cannot be omitted from this list of devices for increasing the real yield to government of its money-issue.

Financial devices that we have yet to discuss are principally of two types. One involves tangible assets, and we turn to it below. The second involves various kinds of elemental primary securities, both private and governmental. These primary issues have come to be the main reliance, in private enterprise economies, for soliciting saving and for taking efficient advantage of a division of labour between spending units that save and other spending units that invest. Primary

issues enter our model in the next chapter.

FINANCE BY EXISTING TANGIBLE ASSETS

In our rudimentary economy, there is no trading in existing assets. But financial restraint has often been relieved, especially in underdeveloped countries, through transfers of land and other tangibles.

Tangible assets may serve the same purpose as money balances do in the rudimentary economy: to transfer surplus budgets of some spending units to the finance of deficit-spending by other units. Any existing asset that a sector is willing to acquire as an alternative to spending on current output releases resources for other uses, including new investment. A community's natural endowment in land is perhaps the least ambiguous illustration of the existing asset that costs the community as a whole little or nothing in terms of current productive effort and that can be traded to savers as a means of diverting their claims on current output into capital formation. But any other existing asset—*objects d'art*, for example, or estates of an erstwhile ruling class—can be used in the same way.

Public lands served admirably in the United States, both in colonial times and later, to secure funds for development purposes. The most famous instances were the land grants to canal and railroad companies by federal and state governments. Most land granted to railroad companies was intended for sale to raise funds for railroad construction. To the extent that the companies sold the land, their need to obtain external funds by other means, including security sales, was reduced. That this was no small matter is suggested by the fact that the land grants to railroads amounted to almost 10 per cent of the entire area of continental United States. Land transactions replaced security transactions at a time when security markets were underdeveloped and a 'land-office business' was possible. Many savers certainly preferred to accumulate land instead of securities in those years, and the saving they released clearly was allocable to new investment.

6

Financing Norms*

H.O. Goldschmidt

This essay views the problem of financial planning from the micro-angle of the firm. The author places the financing problem against the background of the firm's objective and develops the concept of what he calls the 'quantitative liquidity norm' and the 'qualitative liquidity norm'.

Editor

The Connection Between the Financing and the Objective of the Enterprise

In the description of the objective of the firm, the objective is defined as consisting in 'the acquisition of an income sufficiently large to guarantee the firm's subsistence', which implies that the striving after continuity should be the primary consideration. To this, however, the remark may be added that 'within the limits of this continuity principle, the greatest possible profit should be striven after'.

All actions (either inside or outside, and affecting the enterprise) by the entrepreneur or other parties interested in the firm, should, therefore, be directed towards the attainment of the above dual objective.

In order to ensure, as firmly as possible, the maintenance of the enterprise, all such actions must be aimed at raising to

*Taken from H.O. Goldschmidt, *Financial Planning in Industry*, H.E. Stenfert Kroese N.V., Leiden 1956, pp. 100–10.

a maximum value the firm's power of resistance against harmful internal and external influences, and at maintaining it at this level.

Once the course of events within the enterprise has been adapted to the attainment and maintenance of the greatest possible power of resistance, the next effort must be to reach the second objective, viz., by making the difference between proceeds and costs as great as possible.

The above statement to the effect that all the actions in question should be directed towards this dual objective, implies that actions relating to the financing of the firm, too, must be performed in such a manner as to contribute to the achievement of the greatest possible power of resistance of the firm, and to the greatest possible difference between proceeds and costs—at any rate in so far as such financial actions are liable to influence these objectives either directly or indirectly.

That there is a direct relationship between the financial actions and the firm's power of resistance is clear from what J.L. Mey remarks on this point, viz.,

> The power of resistance of the enterprise is determined by its financial and organizational structure, and by the efficiency of the policy pursued by it.[1]

The financial policy pursued by the firm also has a direct influence on its profitability. For, if we represent profit by the following equation:

$$W = O - (Pk + Fk),$$

in which

W = the profit yielded by the course of events within the firm;

O = the proceeds of the quantity of final products turned out in this course of events;

Pk = the total costs of production of the number of productive processes that constitute this course of events;

Fk = the costs involved in financing the course of events in the firm,

then we shall clearly see this interrelation between profitability and financing. For, that method of financing which entails the lowest possible financing costs will have the most favourable

[1]Mey, J.L., *Weerstandsvermogen en financiële reorganisatie van ondernemingen*, Amsterdam 1946, p. 59.

influence on the profitability of the enterprise. Moreover, the method of financing also contributes indirectly to a firm's profitability, since a sound financial policy should be one of the conditions for its optimal development and, with that, for the fullest possible use being made of existing possibilities to make profit.

It may be concluded from the above, therefore, that all financial actions by a firm must subserve that method of financing which

(1) shall strengthen the firm's power of resistance as much as possible, so that its subsistence is not threatened;
(2) shall not be a hindrance to the fullest development of the enterprise, and
(3) involves the lowest possible financing costs, so that profitability on that account will be maximal.

THE QUANTITATIVE LIQUIDITY NORM

The firm's need for capital is an ever varying quantity, which variation is directly related to the volume and the nature of the course of events in the enterprise.

Now if the method of financing is not to jeopardize the subsistence of the firm, and not hinder its further development, then it will, in any case, have to be such as ensure the presence of at least the minimal amount of capital required to-day and in the future. For, if this is not the case, then those goods and performances that cause this need for capital cannot be obtained to the full, so that the course of events must be reduced in volume—or, if even this is not possible, will have to be abandoned altogether. If it is expected that, at some future time, the need for capital will exceed the existing minimal amount, then this will mean either a complete or partial stoppage of production, or—assuming production to be maintained at its present level—a hindrance to further development. It is also possible that, owing to disequilibrium between the need for capital and the minimum amount available, the entrepreneur is compelled to modify the whole or part of the course of events in his business in such a way that a more costly method of production must be resorted to. If this happens, then the absence of the minimum amount of capital will preclude also

the satisfaction of the third condition of efficient financing.

But the volume of the existing amount of capital is not determined exclusively by its minimum limit. Its maximum limit, too, can be stated, viz., on the ground of the third financial demand, i.e., that relating to the costs of financing. For, when more capital is introduced than is necessary, part of it will be lying fallow during the course of events in the firm. We then get what may be called 'over-liquidity'. And since these redundant amounts of money fulfil no function in the 'enterprise the expense entailed by their being introduced will not be defrayed by part of the final result of the industrial process—which means waste. In that case, therefore, the financing costs are too high.

From these remarks concerning the minimal and the maximal volume of the amount of capital to be introduced we now come to the *first financing norm.* For, the financing of a firm should be such as to ensure

> 'equilibrium between the inflow and outflow of money, in such a way that both an excess and a shortage of capital are avoided.'[2]

Since this norm relates to the volume of capital to be introduced, while its application obviates both the possibility of 'over-liquidity' and of 'under-liquidity', this norm may be termed the *quantitative liquidity norm.*

In the Netherlands economic literature there are frequent references to a supposed contradistinction, in the financing of an enterprise, between considerations of liquidity and considerations of costs.[3] As will be clear from the above, such a contradistinction does not exist in so far as these considerations relate to the question of quantitative liquidity. After all, the quantitative liquidity norm rests—in its minimal determination of the volume of capital—apart from considerations relating to the firm's power of resistance and its further development, also on considerations of costs, while the maximal volume of capital is entirely determined by considerations of costs. The

[2]Mey, J.L., op. cit., p. 36.

[3]Cf. Kleerekoper, S., op. cit., p. 356 et seq.; Limperg, Th., *Leer der Financiering*, university lecture; Van der Schroeff, H. J., *Omlooptijd van het vermogen en vervangingsverplichting*, in "25 jaren M.A.B.", Part I Purmerend 1950, p. 219.

relationship between the two points of view, therefore, is not one of mutual opposition: but neither are they in complete agreement. The connection between the two considerations is one of cause and effect. For, the quantitative liquidity considerations are the result of, among other factors, considerations of costs.

THE QUALITATIVE LIQUIDITY NORM

In the above we have consistently used the term 'capital'. The concept 'capital', however, being a collective concept, covers several different kinds of capital.

These different kinds of capital may be subdivided in accordance with two main elements[4], viz.,

(1) the period of time during which the capital in question is tied up in the firm;

(2) the degree to which the capital is tied up in the firm.[5]

Classing types of capital, according to (1)—duration—, we can distinguish

(1) permanent capital, i.e., that capital which is present during the entire life of the firm;

(2) long-term capital, i.e.. capital which, although present in the firm for a lengthy period, yet must be relinquished, either wholly or by instalments, sometime during the firm's existence;

(3) short-term capital, i.e., capital which the firm can use only for a short period to meet its need for capital.

One year is usually taken as the limit dividing short-term from long-term capital.

Taking the degree to which the capital is bound to the firm as criterion for the subdivision of types of capital, we get the following two groups:

(1) the firm's own capital, i.e., that which is its own property;

(2) outside capital, i.e., capital borrowed from sources outside the enterprise, and which, all according to the agreements arrived at, will have to be repaid.

[4]For further points of view, see Töndury, M., and Gsell, E., *Finanzierungen*, Zürich 1948, p. 23 et seq.

[5]Cf. also Van Ketel, A.B.A., *Schetsen uit de financiering der onderneming*, Leiden 1944.

Setting out the various kinds of capital—arranged in accordance with these two points of view—in a schematic representation, we get the following anay:

TABLE 6.1

Duration of bond \ Degree of bond	Degree of bond: Own capital	Degree of bond: Outside capital
Permanent capital	1. Capital introduced by entrepreneur(s) 2. Limited partner's capital 3. Shares 4. Reserves	
Long-term capital		1. Bonds 2. Mortgage loans 3. Other long-term loans
Short-term capital		1. Bank credit 2. Seller's credit 3. Buyers' credit 4. Other short-term loans

While, as is shown above, the capital can be subdivided according to the length of time, it is tied up in the firm, the need for capital, too, is subject to a similar classification as to time. For there is a permanent need for capital caused by those property components that are continuously present in the same value, such as grounds, financial participations, etc., on the one hand, and by the diversity phenomenon, which acts with respect to the slowly diminishing part and with respect to the short-term part of the need for capital, on the other hand. There further remains a slowly diminishing part and a short-term part.

Now it is this congruency in the subdivisions of both the capital and the need for capital from which the second financing norm arises. For, either the subsistence of the firm will be seriously endangered, or profitability will be very adversely affected, if the permanent need for capital should be financed with either long-term or short-term capital. At any moment that this capital is either wholly or partly withdrawn from the firm it will be necessary to replace it at once, since the need

for capital remains unchanged. And it will always be an open question whether the situation on the money or capital market is such as to allow of this replacement in sufficient measure and at a normal rate of interest. If it proves impossible to attract sufficient replacement-capital, the need for capital will have to be adapted to the amount available at the time, which means that either the volume of the course of events in the enterprise, or—if such a thing is possible—its character, will have to be modified. In the former case—as we already saw above—either the partial or the complete liquidation of the existing and/or future course of events in the firm will have to be decided upon—which conflicts with the exigency of the strongest possible power of resistance, on the one hand, and with that of complete development, on the other hand. In the latter case it will be necessary to resort to a different (which, in a well managed firm, means a more expensive) method of production —a thing which is contrary to the demand, set out above, with respect to costs.

If the firm finds itself compelled to attract the replacement-capital at a higher rate of interest than normal, then this will also conflict with the said demand relating to costs.

Similar arguments can be found if the whole or part of the slowly diminishing need for capital should be financed with short-term capital.

The fluctuating need for capital can be financed with short-term capital without either the power of resistance or the possibility of expansion being endangered. For, in this case—as Van Berkum observes,

> on the assumption of remunerative sales, the money flowing back from the turnover (may), after the end of the fluctuation, be used to liquidate the credit situation.[6]

From the above exposition we may conclude, therefore, that, in conformity with the demands set out in the beginning of the present chapter,

(1) the permanent part of the need for capital must be financed minimally with permanent capital;
(2) the short-term fluctuating part of the need for capital, maximally, with short-term capital, while

[6]Van Berkum, P. P., op. cit., p. 10.

(3) the slowly diminishing part and the fluctuating part of the need for capital may together be maximally financed with long-term capital.[7]

In the above we indicated—on the ground of considerations relating to power of resistance, expansion, and costs—the minimal quantity of permanent capital and the maximal quantities of long-term and short-term capital. It should be borne in mind that, in determining the exact amounts of these classes of capital, it is the last-named of these three—considerations of costs—that plays the most important part.

For, if a firm attracts a quantity of permanent capital sufficient to finance the entire course of events in the concern, then there will be over-liquidity in those periods in which its need for capital is below the maximum. As we saw above, this means a loss to the enterprise, even if the amount not required is invested at short-term, since the interest received in return for the loan is usually much lower than the interest one has to pay for attracting outside capital.

As against this, it may be said that—again usually—the interest to be paid on short-term borrowed capital is higher than on long-term capital. As a result of these three rates of interest it is now possible to find that volume of the fluctuating part of the need for capital, for which it is immaterial, from considerations of costs, whether it is financed with long-term or with short-term capital. Financing of a larger part with either long-term or short-term capital, however, would decrease the profitability of the enterprise.[8] Whether the part of the short-term need, determined in this way, should be financed with permanent, or with long-term capital will depend—apart from factors outside the enterprise, such as the situation on the capital market, and factors inside the enterprise, but not of an economic nature, e.g., the 'right of say' in the firm's affairs—also on considerations of an economic nature, such as the stability in the business results obtained, 'so as to ensure a great measure of certainty that the firm will be in a position,

[7]Cf. also De Jongh, B.H., *Beschouwingen over eenige effecten en credietvormen in hun beteekenis voor de financiering der onderneming*. The Hague 1924, p. 7, et seq.

[8]Cf. Polak, N.J., *Enige grondslagen voor de financiering der onderneming*, 7th ed., Haarlem 1940, p. 115, et seq.

under all circumstances, to meet its annual obligations with respect to the payment of interest and redemption',[9] and, finally, on considerations of costs.

The same facts that influence this latter choice will also determine whether, and to what extent, the slowly diminishing need for capital will have to be financed by permanent or by long-term capital.

Reviewing the whole of the above exposition, we may say, therefore, that the *second financing norm* lays down that the financing of a firm should be such as to preclude, on the one hand, the danger of under-liquidity due to a discrepancy between the times when certain classes of capital, in view of their nature, can be available, and, on the other hand, the danger that, at certain moments, there will be over-liquidity to such a degree as to affect the profitability of the enterprise. The content of this norm appears to justify giving it the name of *qualitative liquidity norm*.

This qualitative liquidity norm, too, is based on the demands set out in the beginning of the present chapter, including, therefore, the demand relating to costs. With respect to this norm, therefore, there cannot be any question of a contradistinction between a costs and a liquidity standpoint, as the latter is one of the results of the former.

Since, as shown in the survey on p. 63, the subdivision between permanent capital, on the one side, and long-term and short-term capital, on the other, implies at the same time a division into own and outside capital, it will be seen that the qualitative liquidity norm already indicates the method of financing the enterprise with the aid of these two classes of capital.

The foregoing discussion dealt only with the determination of the volume of the various types of capital falling under the main grouping. As will be seen from this survey, however, further subdivision is possible. The question, which of the components thereby obtained should be used for financing purposes, however, is bound up with many different factors

[9] Manschot, H.J., *De functie van de obligatielening in de financiering van het Nederlandsch-Indische bedrijfsleven*, included in *Bedrijfseconomische Opstellen*, Groningen-Batavia 1939, p. 147.

that can be determined only on the basis of a particular concrete case—the situation on the capital—and/or money market, the legal status and the size of the enterprise being among the most important aspects of the problem. For this reason we shall refrain from going into this question in detail.

TOTAL, OR PARTIAL FINANCING

In the above discussion we have consistently based our argument on a need for capital arising from a *complex* of property components. That is, the firm's need for capital was sub-divided only in accordance with its duration, and not in accordance with the several property components which caused it. The method of financing based on this totality is called *total financing.*

It is also possible, however, to finance each property component separately—subject, of course, to the norms discussed above. We then speak of *partial financing.*

In laying down the financing norms, it will be necessary also to make a choice—with, in the background, the three demands set out earlier between the two methods of financing. Before making this choice one should know the respective advantages and disadvantages of the two methods.[10]

The advantages of total financing above partial financing are due to the fact that, when the need for capital is taken as a totality, then the quantity of permanent capital used for financing purposes—as a result of the action of the diversity phenomenon, discussed earlier and of considerations of costs, discussed already—will be greater than when the need for capital, arising from the property components, is financed separately.

Thanks to this larger amount of permanent capital in the case of total financing the enterprise becomes more independent of the development on the money and/or capital market than with the method of partial financing. For, in the latter case the enterprise will always have to have recourse to

[10]Cf. also Mey, J.L., op. cit., p. 40 et seq., and Mey, J.L., *Enkele beschouwingen over de leer der financiering*, in *Maandblad voor Social-Economische Wetenschappen*, Nov. 1944, Feb. 1945.

the said markets, also during situations in the trade-cycle where there is a scarcity of money or capital, and/or a high prevailing rate of interest.

The consequence of this—as we saw above—may be that the firm may either be compelled to proceed to total or partial liquidation, or experience a downward pressure on its profitability.

Total financing, moreover, also renders the enterprise independent of the development of the general conjuncture, because it will be free from certain repayment commitments and interest burdens, of which the former, in times of slump, may jeopardize the firm's liquidity position, while the latter may adversely affect both liquidity and profitability.

Partial financing, on the other hand, has some advantages deriving from the fact that a larger amount of long-term and short-term capital is used than in total financing. In the first place this will, generally speaking, make financing cheaper. For, in most cases, outside capital attracted from the capital market direct, is cheaper than the firm's own capital, while over-liquidity is more easily avoided or, at any rate, with smaller loss. It is further evident that, with partial financing, adaptation to unforeseen changes can be effected more smoothly than in the case of total financing.

Finally, it is possible for the 'right of say in the management'—a factor outside the economic field—to constitute an argument in favour of partial financing.

On reviewing the above discussion of total and partial financing we may say that, in general, the advantages of total financing relate to the firm's power of resistance, while partial financing yields advantages with respect to its profitability.

Now on the basis of the fact—that, in view of the firm's objectives, all its actions, and also, therefore, its financial actions, should be directed, first and foremost, towards the maintenance of the enterprise, then it is evident that the choice will fall on total financing.

This, however, is not tantamount to saying that there should be no place whatsoever, in the firm, for partial financing. We may, for example, here think of a given, isolated form of capital equipment which lends itself to financing with long-term capital, while the money set free in respect of

depreciation may serve towards the redemption of the long-term capital in question; or of certain stocks financed with supplier's credit; or of certain parts of the productive process that are suitable for financing with buyer's credit—as is often customary in shipbuilding.

In deciding whether a given object is eligible for partial financing, however, it should always be borne in mind that the maintenance of the firm must never be endangered, and that profitability should not be adversely affected.

7

The Setting of Entrepreneurship in India*

Andrew F. Brimmer

This paper shows how the corporate form of industrial organization was adapted to the specific socio-economic conditions prevailing in India during the early period of modern industry. The paper unveils the decision-making process under the managing agency system. The operating companies were apparently independent entities with their own board of directors but were actually legal and accounting fictions, little more than the operating arms of the central decision-making unit—the managing firm. The paper provides a good historical perspective to the development of industrial organization in India.

Editor

INTRODUCTION

The purpose of this paper is to introduce a rather unusual type of industrial organization known as the managing agency system. An attempt will be made to explain its origin and growth and to indicate some of the contributions it has made to economic development Another objective of the paper is to call the attention of Indian students to an approach

*Andrew F. Brimmer, 'The Setting of Entrepreneurship in India', *The Quarterly Journal of Economics*, Vol. LXIX, No. 4 (Nov. 1955),

to the study and appreciation of this institution which is different from the view most frequently taken. The legal aspects of the managing agency system are usually focused on, and most investigations which the author has seen rapidly become inquiries into, the nature and provisions of Indian Company Law and the agents' behaviour within these limits. The result is that the 'illegal acts' and transgressions of specific managing agents constitute the subject matter for discussion.

Our present concern is not primarily with the correctness of this approach, considered by itself, but with the substance of economic activity obscured by preoccupation with the managing agency system as a legal entity. In a wider context, the author would argue that the whole system of company law in India, like the organization of commercial banking, is simply irrelevant. Both of these represent the importation of British institutions into an environment which was alien and inhospitable. However, this broader field is not the one examined here. This writer asserts that legal and economic arrangements developed in the United Kingdom to solve problems arising in the latter were unsuited for India. It is suggested, therefore, that the managing agency system is the Indian answer to the imposition of British institutions as well as a response to the challenge of relative backwardness which characterized the economic scene in India.

pp. 553-76. Reprinted by permission. The author was enabled to do the basic research for this paper by the award of a U.S. Government grant under the Fulbright Act to study in India during 1951-52. For this he is most grateful. The work was continued while the author was a Research Assistant in the Centre for International Studies, Massachusetts Institute of Technology (CENIS-MIT), 1953-54. The number of persons who have enlightened the author by the provision of material, work facilities, comments and criticisms, both in India and the United States, is too large to permit thanking them individually. However, Professor C.N. Vakil, Director of the School of Economics and Sociology, University of Bombay, and Dr. Helen Lamb of CENIS-MIT have been exceptionally helpful and must be thanked separately. Various parts of the material presented in the paper have been discussed in seminars given at Harvard University under the direction of Professors Galbraith and Gerschenkron. Of course, none of these persons or institutions assumes any responsibility for the contents of the paper.

NATURE AND ORIGIN OF THE MANAGING AGENCY SYSTEM

The managing agency system is a type of industrial organization unique to India in which the promotion, finance, and administration of one or more legally separate and presumably independent companies are controlled by a single firm. It is a system of economic and legal relationships which pervades the entire field of economic activity—especially modern industry and trade and commercial agriculture.[1] The system operates within the framework of company law, and both public and private limited joint stock companies as well as partnership undertakings are controlled by managing agency firms. At the very centre of the system is the managing agency firm which may take the organizational form of either a partnership, private or public limited company, or a single individual. The formal and informal relationships between this firm and the operating companies controlled by it constitute the managing agency system. The name of the system arises from the so-called 'managing agency contract' between the agency firm and each company.

CRITICAL ROLE OF THE AGENCY FIRM

It is extremely important, if the system is to be understood, that the nature of the managing agency firm and its relation to the controlled company be fully comprehended. It should be noted that the managing agency firm *is the firm* in the sense in which this term is known in institutional economics. If the firm is defined as the institutional setting in which entrepreneurial decisions are made, it is immediately clear why the managing agency firm should be so designated. Managing agents, the businessmen operating through the managing agency firm, are the real entrepreneurs in India. They have been the ones primarily responsible for the introduction of new products, new methods of production, and new sources of raw materials; they have discovered and exploited new markets and have usually undertaken

[1] P. S. Lokanathan, *Industrial Organization in India*, George Allen and Unwin, Ltd., London, 1933, p. 5.

whatever reorganization Indian industry has experienced.[2] To achieve these ends, the managing agents have generally made use of the joint stock form of organization for the companies launched to undertake actual production and trade. These latter companies should be considered as operating units of the central, decision-making unit—the managing agency firm.

Whatever the legal form which the managing agency firm assumes, it is typically composed of a group of individuals who have either large financial resources (or access to such) or a considerable amount of general business and technical ability, or both. The composition and functioning of the agency firm may vary depending upon whether it is controlled primarily by Indian or British businessmen. (Why this is so is explained below.) The managing agency firm has many instruments by which it maintains control over the operating company. The most important of these are: (1) the management contract, (2) financial practices, and (3) share and voting arrangements. The management contract is an agreement between the agency firm and the operating company which specifies their respective rights and obligations. It is drawn within the framework of the Indian Companies Act, 1913 (amended, 1936). Consequently, the agreement is a legal document and has status in the law courts. Financial holdings of the agency firm in the controlled companies were once the chief means of securing control. In recent years there has been a tendency for agency firms to reduce their holdings of shares issued by operating companies, but they continue to occupy a crucial place in matters of finance. A proven instrument for control exists in the use of shares with special voting rights which are issued to the managing agents only.[3]

Although the operating companies may appear to be independent entities with their own boards of directors, they are usually legal and accounting fictions which serve to give the agents a greater degree of freedom, financial and otherwise. In most cases the board of directors of the operating company

[2]Daniel H. Buchanan, *Development of Capitalistic Enterprise in India*, New York, 1934, p. 145.

[3]M.A. Mulky, *The New Capital Issue Market in India*, New Book Company, Bombay, p. 75.

is selected by the agency firm.[4] In practically every instance several members of the agency firm are also directors of the controlled company. More often than not, one of these agency directors is chairman or managing director of such a company. While the managing agent presumably functions under the supervision of the board of directors, the latter is frequently nothing more than a fiduciary body which exists to persuade the public to invest and to fulfil legal requirements. A look at the large number of 'prestige' directors—'Sirs', 'Rajas', 'Rai Bahadurs', etc.—on the boards of Indian companies will make this suggestion quite obvious. Thus, the managing agency firm is responsible for practically all decisions made in the companies under its control.

BRITISH AND INDIAN AGENCY FIRMS CONTRASTED

The above picture of the managing agency system is a generalized one. If British and Indian agency firms are examined separately, some modifications must be made in regard to details. However, the general outlines of the system are not greatly changed. The typical British agency firm is a partnership which continues to combine financial resources and technical and business ability through the selection of its members.[5] Such a firm is likely to have one or two 'old family' men who have inherited their position. They may or may not be technically competent. However, they usually are, and if they are not they are unlikely to be in a position to obstruct the efficient operation of the agency firm. In either case, they give continuity to the firm through the maintenance of the family name. In addition to such family representatives, there are always two or three partners selected from the group of senior assistants. The latter officers have usually progressed through the various operating companies under the control of the agency firm and have acquired considerable knowledge of their activities. In most cases, they have begun as junior assistants brought out from

[4] Bombay Shareholders' Association, *Memorandum on Directors*, Bombay, 1949, pp. 8-9.

[5] Lokanathan, op. cit., and Wilfred Russell, *Indian Summer*, Bombay, 1951, p. 47.

England and Scotland in their early twenties. Frequently, they come with the idea of making a career of service with an agency firm and eventually becoming a partner in it. Many succeed.

Each partner in the British agency firm usually rotates as executive officer of one or more of the 'departments' within the firm. A typical British Agency firm will have the following departments: accounts and finance, export and import, labour welfare, mills and works, purchasing, research and development, sales and advertising, transportation. In addition, each partner will serve as director, managing director, or senior officer of one or more of the operating companies. When the nonfamily partners retire from the agency firm, they are almost never replaced by their sons. Consequently, the British agency firm is constantly drawing in new blood and new money when the senior assistants become partners.[6]

The typical Indian agency firm differs from its British counterpart in several respects. However, these differences can be understood only in the context of the traditional organization of Indian business. For centuries practically all business activity was concentrated in the so-called trading communities. The latter are remnants of the process of fragmentation through which the older fourfold caste system has gone. The origins of this system need not detain us here, for it is sufficient to note that occupational stratification was one of its cardinal features.[7] Within each Hindu trading community the common unit of economic activity was coterminous with the familial organization. The eldest male, so long as he was not incapacitated, was the chief administrator of the family fortune. Other male members—and sometimes females—participated in the activities of the firm under the direction of the family head and shared (not always equally) in the gains. As long as the family remained a unit, the firm continued to function. for both tradition and law clearly specified the rights of succession.[8]

[6]Russell. op cit., p. 58.

[7]D.R. Gadgil, "Notes on the Rise of the Business Communities in India". New York : Institute of Pacific Relations, 1951, pp. v-vi.

[8]G S. Ghurye, *Caste and Race in India*, London, 1932, pp. 28-29. And Sir Edward Blunt, 'The Economic Aspects of the Caste System', in R. Mukerjee (ed.), *Economic Problems of Modern India*, London, 1939. p. 64.

This was, of course, a great element of stability, but it may not have fostered maximum efficiency. Finally, there existed between the family-firm and the trading community of which it was a member an informal relationship symbolized by a very strong sense of responsibility for the well-being of one's community fellows and an overt preference for dealing with them.

Of course, it is not necessary to dwell upon the fact that the traditional bonds and conditions discussed above have been weakened considerably. The trading communities are no longer the sole Indian participants in business activity. The joint-family has lost much of its former hold on the individual members, and the family-firm is no longer the only crucible of family fortunes. The overt preferences for caste fellows is not so frequently met as it once was. Nevertheless, the legacy of the past has a reality all its own and serves to shape the mode of operation of the Indian managing agency firms.

The managing agency form of organization was adopted quite widely by the Indian merchants when they began to operate in the industrial field. But unlike the British agency firms, the Indian agency houses are primarily financial in character.[9] Apart from a few exceptions,[10] the Indian agency firm is typically a simple extension of the older family-firm relationships. This fact is reflected in the composition of the firm, its sources of finance and the way in which it operates the companies under its control. While one encounters Indian agency firms organized in the form of private limited companies, the usual form is a partnership. Within the partnership, the members are most frequently related by blood or marriage, and in practically every case, they are—at the very least—members of the same caste. The sons of the partners, irrespective of ability—tend to follow the fathers in unbroken succession.[11] Despite the relatively large size of Indian families, this means that the field from which senior members of the firm are recruited is extremely limited. In addition, the Indian agency firm tends to look for junior assistants and other staff members first

[9] Lokanathan, op. cit., pp. 315–19.

[10] The most widely known of these exceptions are the House of Tata, Birla Bros., Khatau & Sons, and Wadia and Sons, Ltd.

[11] Gadgil, op. cit., p. vii.

among the members of the agents' family and secondly among their community or subcaste. Only very infrequently do they go beyond these bounds to obtain persons for staff and administrative posts.[12]

Since members of the Indian agency firms, in general, have little technical competence, they occupy their position chiefly on the basis of the family funds invested therein. These funds have frequently been accumulated through trade and constitute the major contribution which the Indian managing agents make to the agency firm as well as to the operating company or companies under the latter's control. Another way in which the financial character of the Indian firms is revealed is the transfer of managing agency rights in an operating company from one agency firm to another. The receiving agency firm almost invariably has greater financial resources than the vending firm and only occasionally is the former superior to the latter in the way of industrial experience.[13]

With a few notable exceptions,[14] the Indian agency firms seem to administer the operating companies under their control with a view to obtaining the maximum amount of profit in the shortest possible time. There appears to be little attention given to the maintenance of plant and equipment or to the long-run planning and development of markets and raw materials. As indicated above, there is practically no effort made to recruit and train a staff on the basis of objective personnel criteria. Though the technical staff of most Indian agency firms must be employed, questions of tenure and job security apparently are seldom, if ever, discussed. When Indian firms adopt accounting procedures (as required by law for the public limited companies under the agents' control), they often do so in order to conceal rather than explain the operations of the company.[15]

In general, most of the British agency firms approximate in structure and functioning the desirable aspects of the

[12]Leslie Sawhny, 'Management and Training in Industry', *Commerce and Industry*, Madras, February 14, 1954.

[13]Bombay Shareholders' Association, *Memorandum on Managing Agents*, Bombay, 1949, pp. 1–31.

[14]See the agency houses listed in note 15, p. 73.

[15]S.D. Mehta, 'Some Aspects of the Managing Agency System', *Journal of the University of Bombay*, Jan. 1953.

managing agency system. With few exceptions Indian firms seem to embody many of the undesirable features. In reaching this conclusion, it is necessary, of course, to distinguish between the desirable and undesirable features of the managing agency system and those practices followed by specific agency firms. The contributions which the British agency firms have made to the development of Indian industry are contributions made by seasoned entrepreneurs operating through the agency firm. Likewise, the detractions made by Indian agency firms have been made by businessmen still in the process of maturing. Consequently, the worthiness of the system must be judged in terms of what use various business groups have made of it. In the hands of the British and the more advanced Indians, the system has been a powerful instrument of economic development: in the hands of the more irresponsible Indian businessmen, it has been an equally powerful instrument for manipulating enterprises to the advantage of controlling families but usually to the disadvantage of the country as a whole.

ORIGIN AND DEVELOPMENT OF THE MANAGING AGENCY SYSTEM

The exact origins of the managing agency system are still disputed. However, most writers on the subject seem to agree that its roots go deep into the social and economic conditions prevailing in India at the time the East India Company lost its monopoly of trade. The evidence indicates that the system evolved out of attempts to overcome two limitations on the appropriation of business opportunities then prevailing in India:[16] (1) a shortage of entrepreneurial ability and (2) a shortage of venture capital. The continuing presence of these limitations seems to go a long way in explaining the continued existence of the system.

During the early nineteenth century, India offered a number of opportunities to energetic businessmen. Its large population, despite the low standard of living, presented a relatively large demand for consumer goods—especially cotton textiles. Although the latter were widely produced in India, the methods of production were backward when compared with the

[16] Lokanathan, op. cit., pp. 15-16.

power-driven mechanical techniques which were then revolutionizing industry in England. Also, India's large capacity to produce industrial raw materials was as yet underdeveloped. At the same time, the supply of business leadership was small. There were very few indigenous Indian businessmen who were able to move from the traditional trading and financing in local markets to the new forms of production. To profit by the opportunities then available, required a knowledge of foreign markets and sources of supply. It also required a mastery of new forms of organization and widespread connections in the world economy then in the process of emerging. The field was open in India, and the British general merchants were on the scene.[17]

There is some evidence which suggests that several British firms were trading in Bengal in the late 1790's with arrangements similar to those which characterize the modern agency firm.[18] In general, it seems that former servants of the East India Company set out as general merchants on their own account. As general traders and factors, they acquired a detailed knowledge of local markets and ways to exploit them. Given their connections with firms in England, America, and other parts of the world, this new knowledge of Indian conditions placed these merchants in a position to appropriate new opportunities as they emerged.

In addition to the relative shortage of entrepreneurial ability, there was also a drastic shortage of venture capital. Despite the numerous fortunes accumulated by Indians in trading and agricultural activity, the supply of funds to finance the projects of the British general merchants came primarily from the merchants and a few of their friends and associates.[19] The usual procedure followed by the agents in the launching of new enterprises was as follows: As promoters, the agents would make the necessary investigations concerning cost and availability of labour, raw materials and other inputs and the nature and extent of markets. The agents would also organize and register the company as a legal entity, selecting in the process

[17]William W. Hunter, *The Indian Empire*, London, 1893, pp. 658-59.
[18]Ibid.
[19]Russell, op. cit., p. 63.

the first board of directors. Initially the agents would issue only a small part of the authorized capital of the new company and—with their friends and associates—would take up most of the issued shares. If debentures were floated, the agents would also hold these. Once the enterprise had proved itself, the agents would issue most of the remainder of the authorized capital—usually preference shares—and invite the public to subscribe to the securities. At the same time, the agents would very likely throw some portion of the shares originally held by themselves onto the market. In this way, the agents supplied capital to the new enterprise in the most critical time.[20] Once he had regained his initial investment—frequently with a considerable profit—the agent was able to repeat the process with a new enterprise. As will be more fully explained below, the agent was also able to shift funds from one enterprise to another through the medium of the agency firm.

Although the conditions discussed above may explain why the British merchants developed the managing agency system, the question of why Indian businessmen adopted it must be answered. The first clue, of course, must be sought in the same conditions which made the British develop the system. The supply of Indian entrepreneurs was equally as limited as that of the British. The more enterprising of the Indian traders (notably Parsis and Gujeratis) turned to trading in cotton and similar goods soon after the British came to India. By the middle of the nineteenth century, the Parsis, who had forged the strongest connections with the British whom they served initially as middlemen, were able to branch out into the manufacture of cotton textiles.[21] The latter industry has been the basis of most of the accumulations which have gone into other industries in which Indians have played a major part. The agency system proved a highly useful framework within which business ability could be put to the best advantage. Like the British, Indian businessmen found that the agency system could be used to overcome the handicap of capital shortage.

Another factor contributing to the widespread use of the system by Indians lay in the nature and functioning of the

[20]Lokanathan, op. cit., pp. 14-27.

[21]Buchanan, op. cit., pp. 270-71 and Gadgil, op. cit., pp. vi-vii.

banking system in India.[22] The loan criteria used by the Imperial Bank of India, and other leading joint stock banks before it, gave to the managing agents a crucial role in obtaining bank credit. Like the English banks on which they were patterned, Indian joint stock banks limited their loans to the supply of working capital, accepting the hypothecation of goods as security. However, the banks argued that goods were likely to vary greatly in price—and price instability was especially true of cotton and piece goods in which Indians traded to a large extent—and it was, therefore, necessary to have someone on whom the bank could rely to make good the loan. This someone was clearly the managing agent; for while Indian joint stock companies showed a high propensity to go bankrupt, the agency firm displayed a much higher survival rate. As a result, the practice grew up of having two signatures on notes of indebtedness, one a director of the company and the other the managing agent.[23] Thus, in order for a company to obtain even the limited amount of credit the banks were willing to advance, it was mandatory for the company to be under the control of a managing agent.

Finally, as indicated above, the agency system possessed much flexibility from the point of view of a small group of businessmen with a limited amount of capital but looking to the development of industrial and commercial enterprises. At the same time, the system was equally as flexible in the hands of persons who were primarily interested in manipulating finances among various companies for the sole purpose of enriching the managing agents. An agency firm was able to transfer funds from one company to another regardless of the soundness of the receiving unit. A prosperous undertaking could be made the basis for raising funds in the capital market for use by companies whose own credit standing would not warrant confidence.[24] Because of the concentration in the hands of the managing agents of purchasing and marketing

[22]S.K. Muranjan, *Modern Banking in India*, Bombay, 1952, pp. 289-321.

[23]D.R. Samant and M.A. Mulky, *Organization and Finance of Industries in India*, Calcutta, 1937, p. 45.

[24]Bombay Shareholders' Association, *Managing Agents*, pp. 41-74.

arrangements of various controlled companies, the best interest of any individual company were not always served. This ability to conceal the actual status of each operating company behind the multiplicity of interlocking balance sheets also gave the agents a considerable amount of leeway if they chose to utilize it in escaping taxation of earnings. The evidence suggests that many Indian agency firms selected the agency system as much for these predatory activities as for the more socially desirable ones described above.[25]

Despite the transgressions which the managing agency system allows to businessmen who wish to make them, one cannot avoid concluding that the system has gone a long way in reducing the limitations and disadvantages which enterprising businessmen had to face in their attempts to answer the challenge of industrial backwardness in India. For one who wishes to explore them, the numerous problems created by the separation of ownership and control in joint stock enterprises are multiplied many times in the agency system. But this writer argues that if one focuses not on the legal aspects of the agency system but on its economic characteristics, the managing agency firm comes into full view as the heart of industrial organization in India. Consequently, if this organization is to be fully appreciated, the numerous, legally distinct, producing companies must be treated simply as operating arms of the managing agency firm.

THE SCOPE OF THE MANAGING AGENCY SYSTEM

No matter how extensively one reads in the various standard works in Indian economics, it is not possible to obtain a clear view of the place the managing agency system plays in that country's economy. A comprehensive quantitative appraisal of its scope is yet to be made. It is obvious, however, that such a task will be almost impossible to carry out. In the first place, as explained above, the activities of managing agency firms—while the substance of Indian enterprise—are generally hidden behind the shadow of joint stock and private companies through which the agents operate. The operating companies,

[25]Ibid.

when publicly registered, constitute the visible superstructure: beneath them, in the byways of partnership and private arrangements, are the crucial mechanisms of business activity encompassed by the managing agency firm. Almost no public records exist to illuminate these.

Secondly, much of general economic activity is not carried on through the instrument of publicly registered joint stock companies. Under the Indian Companies Act, 1913 (amended, 1936), any group containing not more than fifty members can register itself with the proper authorities as a private company with limited liability. It can issue stock of a specified nature, and so long as this stock is privately held, it can engage in any kind of business except scheduled banking and insurance.[26] It is in this form that a significant portion of Indian business is carried on.

INDUSTRIAL DISTRIBUTION OF THE AGENCY SYSTEM

Nevertheless, the need for such statistical knowledge is obvious. Otherwise, discussion of the managing agency system must continue to have an air of unreality about it. In an effort to cast some light on this area, the author undertook an exploratory investigation using data from one of the largest *Yearbooks*[27] which contains information relating to companies registered on the various Indian stock exchanges. Of the 1,427 companies for which complete information was given, 94 were banks, 70 insurance companies and 20 managing agency firms. These 184 companies were set aside, the banks and insurance companies for the reason explained above, and the managing agency firms because they were not likely to have other managing agency firms directing them. Thus, there were 1,243 companies studied. All of these could have been legally controlled by managing agency firms. The number with managing

[26]Scheduled banks are those with deposits of Rs. 500,000 and are included within the Reserve Bank System. Both scheduled banks and insurance companies must be publicly registered joint stock companies. Neither can enter into a managing agency contract with another firm or individual.

[27]*Investors' Encyclopaedia*, Madras, Kothari and Sons, 16th Edition, 1951–52.

agency contracts was 1,064—leaving only 179 companies without managing agents. This meant that managing agents dominated more than 85 per cent of the companies listed on the stock exchanges. While it is not possible to give a close estimate of the proportion of total production handled by these firms, other data suggest that the ratio is very high in the industrial sector.[28]

The 1,064 companies were classified under seventeen industries. There were three industries, coal, shipping and cement, in which all the companies found were controlled by managing agents. In four others—jute, cotton, railways and North India Tea Estates—more than 90 per cent of the companies were under the direction of managing agents. These seven industries had 523 or 42 per cent of the companies analyzed. With the possible exception of railways (most of which are owned by the government) and cotton textiles (in which handicraft and small-scale units play a large part), the publicly registered joint stock companies are responsible for the bulk of the output in these industries. These are among the most fully developed industries in India.

Four other industries in which managing agents controlled more than 80 per cent of the producing units are engineering, electric power, vegetable oils and planting (mostly coffee, rubber and nuts). Out of 310 companies in these industries, 265 (85 per cent) had managing agents. It should be noted that the engineering industry contains such crucial firms as those producing iron and steel, industrial machinery and agricultural implements. Actually, industries in which 70 per cent of the firms are controlled by managing agents probably could be classified as being under the latter's domination. Sugar, paper manufacturing and mining and chemicals are in this category. In conclusion, one can say with a high degree of confidence that the managing agency system permeates the entire field of modern industry in India in which private enterprise is most active.

TYPE AND SIZE OF AGENCY FIRMS

The exploratory study also revealed another interesting

[28]Mehta, op. cit.

feature of the managing agency system. The 1,427 companies analyzed were under the direction of 844 management units. These latter consisted of 524 managing agency firms and 320 individuals. With respect to the agency firms, it was found that the private limited company is the most popular organizational framework. About 66 per cent (346) of the agency firms fall into this category. The number of partnerships (156) is less than half as large. Public limited companies were 22 in number and only 5 per cent of the total management firms. Two of the managing agency firms with public registration were actually operating companies which also held managing agency contracts with other operating companies. There were 363 companies with individual managers. This number includes the 184 companies which were either banks, insurance companies or managing agents. It follows then that only 179 of these companies could have had managing agents. Further the bulk of these 363 companies (82 per cent) was managed by an individual with only one company under his direction. Even so, one should not conclude that such an individual was not a hired servant of some managing agency firm. For example, it is reported that some of the large banks are owned or controlled by several of the leading managing agents. (Tata is said to control the Central Bank of India, Birla, the United Bank and Dalmia, the Bharat Bank.) The 23 individuals who managed the remaining 66 companies seem to have between two and three companies each under their direction.

What is probably one of the most interesting aspects of the managing agency system was thrown into focus by the study. It was discovered that 77 per cent of the managing agency firms (404) controlled only one company each. On the other hand, the remaining 120 firms controlled 660 operating companies—62 per cent of the total number of companies controlled by agents. From these statistics, it is obvious that the managing agency system is not composed of firms possessing comparable economic power. On the contrary, there appear to be scattered groupings of very large firms surrounded by an extensive field of small units. What is the reason for the existence of the one-company agencies?

The author confesses that he has no satisfactory xplanation. However, certain aspects of the matter may point

toward an answer. The first thing to note is that every one of the 404 one-company agencies is Indian. Secondly, the bulk of them is found in cotton textiles and among such miscellaneous industries as soap-making, biscuit and bobbin manufacture, coir, glass, woodworking, etc. In this section of the cotton textile industry as well as in the miscellaneous industries, the amount of capital invested in each operating unit is quite small. There is almost no public participation despite the adoption of the joint stock form of organization.[29] The incentives to use the managing agency system were discussed earlier. Of the 404 one-company agencies, 255 represented that many *separate* businessmen or associated groups. These 255 perhaps can be explained by the conditions mentioned in the above discussion. The data indicate, however, that there are 29 individual businessmen in control of the remaining 149 one-company agencies. This is an average of about *five one-company agencies per individual.* Why do these businessmen follow the practice of setting up a new agency firm when they decide to undertake an additional producing activity? It has been pointed out that some of the largest British and Indian agency firms control operating companies in such diverse fields as cement, cotton textiles, jute, sugar, shipping, planting as well as trade. Why, then, this effort at separateness among some Indian businessmen?

The reason for this behaviour probably lies in the fact that most Indian businessmen launch their business careers as traders and continue to rely on trade as the chief source of income.[30] If such a businessman were to concentrate all of his assets in one agency firm and engage in both trade—a relatively safe activity—and experimental manufacturing, he would expose his entire fortune to the vicissitudes of a field in which he possessed little competence. If the manufacturing ventures employed borrowed funds (and most would have to borrow working capital even when the businessmen as owners and agents supplied the fixed investment), the managing agents would have to guarantee the loan personally. Under these conditions, it is safer to launch a new agency firm for each

[29]Samant and Mulky, op. cit., pp. 224-49.
[30]Gadgil, op. cit., pp. 29-32.

project than to group several unproven projects under the same firm. The financial losses arising from the risk of failure of a single operating enterprise are restricted to that enterprise and its immediate managing agency firm; the gains from the same can be appropriated by the businessman who controls all of them.

From the above discussion, it is clear that the managing agency system has been an important instrument for reducing the limitations imposed on industrial growth by shortages of capital and business ability. It has also been a powerful lever in the hands of those who wish to manipulate investments and investors so as to improve their own positions rather than that of the country as a whole. The data presented show that the system is employed throughout the industrial sector of the Indian economy, and its influence extends even further.

Relations Between the Agency Firm and Operating Companies

The scarcity of material for studying the relations between the managing agency firm and the companies controlled by it is extremely difficult to overcome. It is practically impossible for one not connected with the firm to get inside to observe its organization and functioning. Such a position is required, however, before an account of the decision-making process can be given. This author hastens to admit that he was not so fortunate as to study any agency firm from that vantage point. The writer did have the opportunity of meeting representatives from several agency firms who were kind enough to answer most of his questions. In addition, officers of the Bombay Shareholders' Association, who concern themselves primarily with the affairs of companies in which the Association's members have invested, were quite helpful in providing material from their files. These data, combined with information from the stock exchange yearbooks, made it possible to draw several of the major outlines of the relations between the agency firms and the operating companies.

Available materials throw light on four areas of agency-company interrelations. These concern the nature of the managing agency contract and the rights and obligations it specifies,

financial relations between managing agents and controlled companies, the use of special shares to maintain control, and the position and authority of company directors.

THE MANAGING AGENCY CONTRACT

It is not an easy task to obtain copies of managing agency agreements. The author, through the facilities of the Bombay Shareholders' Association, was able to examine two dozen of these contracts.[31] These were said to be representative of the general contents of such agreements. The more common aspects are the following:

Each agreement specifies the parties to it (agency firm and operating company) and sets forth the period of time during which it is to be effective. The conditions of termination and renewal are also indicated. The average duration of the twenty-four contracts was twenty years. Five were made for a period of thirty years. Although this group of contracts contained none with a life longer than thirty years, the author was informed that several companies investigated by the Bombay Shareholders' Association had contracts which covered the entire life of the company. The Government of India is currently considering a proposal which would limit the length of managing agency agreements to fifteen years.

One of the most important provisions of the agreement specifies the amount of remuneration the managing agent will receive and the methods by which it is to be computed. A typical provision sets compensation in the form of a commission of 10 per cent of annual net profits of the company. Other provisions usually specify whether the managing agents are to share in profits by the operating company from the sale of assets or capital gains. In most instances, companies pay the managing agents a monthly allowance to defray the cost of office administration on behalf of the operating company. Among the twenty-four contracts examined, eighteen provided for office allowances ranging from Rs. 1,000 to Rs. 10,000 per month, the average being Rs. 2,500.

[31] As a condition for obtaining access to these contracts, the author had to agree not to identify the companies concerned.

Although most agency agreements pledge the agents not to undertake business on their own account in direct competition with the managed company, few prevent the agents from acting as managing agents for other companies engaged in the same type of activity. That this situation frequently leads to conflicting interests between agents and the different companies under their control has been commented on many times. However, if one takes the view presented in this paper—that the managing agency firm is the crucial decision-making unit and the companies under its control are simply operating arms—this conflict will lose much of its apparent significance.

A study of the twenty-four contracts mentioned above, shows the wide scope the agency firm has in the affairs of the controlled company. Subject to the control of the directors of the company (extremely weak), the managing agents have the general conduct and management of the business and affairs of the company. The agents have the power to enter into all contracts (except the one with themselves!!) on behalf of the company. They have the authority to initiate and abandon on their own decision all legal proceedings involving the company. The agents are solely responsible for the purchase, maintenance and sale of all raw materials, and with the sanction of the board of directors they decide all expenditures on fixed investments. Likewise, the agents have complete control of the financial affairs of the company. It is they who receive all money payable to the company from all sources; it is they who pay *all bills. Their signature appears on all financial instruments*, and they alone buy and sell government bonds on behalf of the company. *All* employees of the company—professional, clerical, skilled and unskilled—are engaged and dismissed by the managing agents. These employees are placed on the payroll of the company, but it is the managing agents who decide the salaries, wages and other benefits they receive.

FINANCIAL RELATIONS

The financial holdings of the managing agency firm in the operating companies were once considered to be the primary basis of the former's control over the latter. This is no longer true. Although the extent of holdings will vary, almost every

agency firm will hold some portion of the capital of the companies under its control. Different writers have given percentages for the agency firm's share which show considerable range. These have varied from as low as 1 per cent to as much as 75 per cent.[32] Of course, it is practically impossible to obtain reliable information on this question on any significant scale.

The author was able to obtain information which may cast some light on the subject. The statistics in Table 7.1 relate to the holdings of a Bombay managing agency firm in seven operating companies under its control, its holdings in another managing agency firm, and the extent of investment of the first agency firm in one of the operating companies controlled by the latter.

Because of the lack of comparative data, the author is not in a position to appraise the representativeness of these figures. Nevertheless, the table is interesting in itself, for it gives some indication of the variety of activity in which a managing agency firm engages.

A more important aspect of industrial finance in India under the managing agency system is shown in Table 7.2. The meaning of the column headings is as follows: Column (2) includes the funds raised in the capital market on the account of one company under the managing agency firm listed in Column (1) but subsequently transferred to another company under the same agency firm. Column (3) shows the amount of loans and advances made by one operating company to another, both being under the control of the same agency firm. Likewise, column (4) shows intercompany investments by companies under the same agency firm. Book debts in column (5) are those which reflect the net value of goods and services supplied on credit to each other by various operating companies. Column (6) is the net amount loaned to the agency firm by the operating companies. The number of companies involved in each group varies widely, from more than fifty on the part of the Dalmia and Birla Groups to less than five for the Narang agency firm. The data have been compiled from the source indicated in the table.

[32]See the Appendices to Ch. I of P. S. Lokanathan, *Industrial Organization in India*, London: 1933.

TABLE 7.1

KILLICK INDUSTRIES LTD.. INVESTMENTS IN OPERATING COMPANIES (*Rs. in Thousands*)

Name of Operating Company	*Capital of Company*			*Agency Holding*			*Ratio of Agency Holdings to Total*		
	Total	*Equity*	*Debt*	*Total*	*Equity*	*Debt*	*Total*	*Equity*	*Debt*
Ahmedabad El.ctric	47,466	34,966	12,500	993	793	200	2.1	2.3	1.6
Bombay Suburban Electric	9.373	9,373	—	500	500	—	5.3	5.3	—
C. P. Railway	9,400	9,400	—	n.a.	n.a.	n.a.	—	—	—
Hingir Rampur (Metal Mining)	1,200	1,200	—	237	237	—	19.7	19.7	—
Kohinoor Mills (Cotton)	10,000	10,000	—	449	449	—	1.5	1.5	—
Shivrajpur Syndicate (Mica Mining)	525	525	—	10	10	—	1.9	1.9	—
Surat Electric	2,500	2,500	—	103	103	—	4.1	4.1	—
Total	80,464	67,964	12,500	—	—	—	—	—	—
Cement Agencies, Ltd	800	800	—	240	240	—	30.0	30.0	—
Associated Cement Co.	88,038	88.038	—	569	569	—	0.6	0.6	—

Source : *Commerce* (Bombay: Nov. 1948).

n.a.=not available.

TABLE 7.2

INTERCOMPANY FINANCING UNDER MANAGING AGENCY FIRMS, 1947 (*Rs. in Thousands*)

(1) *Managing Agency Firm*	(2) *Transfer of Capital, Market Borrowings*	(3) *Net Intercompany Loans and Advances*	(4) *Intercompany Investments*	(5) *Book Debts*	(6) *Net Loans to Managing Agents*
1. Dalmia Group..................	16,976	13,991	34,463	12,893	—
2. Walchand Hirachand Group......	1,297	5,800	12,958	—	—
3. Narang Group..................	546	—	3,800	—	—
4. Birla Group..................	3,000	2,400	10,858	—	—
5. Kamani Group..................	1,000	704	—	1,200	728
6. Cassamally Munjee Group.......	—	—	—	—	237
7. A.V. Thomas Group..........	—	—	507	—	17
8. Andhra Engineering Group......	—	—	—	—	225
9. Modi Group..................	—	2,760	—	—	—
10. Hukumchand Group............	487	—	—	—	1,762
11. Karamchand Thaper Group......	1,250	1,729	150	—	1,414

Source: Bombay Shareholders' Association, *Memorandum on Managing Agents*, Bombay: 1949, pp. 41-74.

The financial advantages of the managing agency system when looked at from the point of view of the agency firm are quite obvious when one realizes that the behaviour pattern indicated in the table is followed quite generally by a considerable number of managing agency firms, British and Indian. With the agency firm in a position to transfer funds from one operating company to another at will, it is clear that an agent can nourish or strangle any company under his control to any extent he desires, his power to do so being limited only by the total amount of funds available to all the companies. The ability of the agency firm to carry out such financial manoeuvres is often criticized by stockholders, but the latter are helpless to do anything about it. They must rely on either their vote or the authority of the directors of the company to prevent such practices. As shown below, the directors are mostly strawmen shielding the managing agents who can usually muster enough votes through their own holdings and proxies to dominate any shareholders' meeting.

CONTROL OF VOTING RIGHTS BY THE AGENCY FIRM

Another facet of agency-company relations is the tendency of the promoters of the operating company to keep control in their hands by the issuance of deferred and other types of shares with special voting rights. (These shares are also issued at times for the agency firm itself if it adopts the form of a limited liability company.) Such deferred shares are usually of low denomination with disproportionate rights as to voting, dividends and distribution of assets on winding up as compared with the other high denomination shares. Invariably, the deferred shares are allotted to the managing agents and their associates. Thus, with a small total investment, the managing agents can control the firm, for these shares always have the same voting power as ordinary shares. They do not normally receive dividends until the common shares have received a specified percentage—often between 5 and 8 per cent. Then, however, these securities almost always participate *pari passu* with the common shares, which means that the rate of return on deferred shares is extremely high. The author was able to examine the capital structure of twenty

managing agency firms which are public limited companies. Among these firms, three had issued deferred shares. In two cases, the firm had raised 25 per cent of the total capital from deferred shares, but these shares entitled the managing agents who subscribed to them to 50 per cent of the total voting stock. In the other case, deferred shares accounted for only 5 per cent of the capital raised but had 55 per cent of the voting power. The data relating to the operating companies controlled by the agents show that about 60 per cent of the former have issued deferred shares. However, it was not possible to discover who owns them. These examples seem to indicate that the use of special voting shares is resorted to by managing agents as one of the chief means of maintaining control of the operating companies.

ROLE OF BOARDS OF DIRECTORS

The author heard much discussion in India about revitalizing the boards of directors of joint stock companies by turning over to them the affairs of these companies. Such steps, it was argued, would lead to a closing of the breach between ownership and control and removal of the managing agents as the dominant force in industrial organization. This author suggests that the legal abolition of the managing agents would not result in removal of the agents as controlling factors. Aside from the contractual relations between the agency firm and the company as defined in the agreement, the managing agents occupy their position because of the business ability of the members and employees of the agency firm. Destruction of the agreement would leave the latter very much intact.

In this area, as with other aspects of the problem, it is difficult to obtain data with which to appraise the role of the managing agents in their relations with the controlled company. In an effort to remedy this situation, the author analyzed data relating to the twenty managing agency firms with public registration mentioned above. Of course, the generality of these data is limited by the preponderance of British agency firms among the twenty. The picture for an equal number of Indian firms would probably change some of the details.

Among the twenty agency firms were four controlled by,

Indians and sixteen by British. There were in these firms 120 directors: 77 British and 43 Indian. Of these 120 directors, 73 held directorships in the 208 operating companies controlled by the agency firms. The 208 controlled companies provided 968 directorships. Although the 73 agency directors were only 15 per cent of the 488 men serving on the boards of the 208 companies, they held 32 per cent of the directorships in the latter.

The dominant position of the agents is emphasized more strongly when one isolates the 'working' directors from those found on the boards for 'prestige' purposes. In India, the latter are mainly titled persons who occupy their seats through the invitation of the managing agents. Among the 488 men holding directorships in the 208 companies were 129 with titles. Nineteen of the latter were also on the boards of managing agency firms. All of the remaining 110 titled directors found only on the boards of the operating companies were Indians. Their titles included 23 'Sirs' and 87 'Rajas', 'Rai Bahadurs' etc. These 110 purely prestige directors held 269 directorships, while 19 agency directors with titles held another 57. If the agency directors and the prestige directors are combined on the basis of a common interest, they number 183 persons with 581 directorships. This is 38 per cent of the total number of directors with 60 per cent of the total directorships in the 208 operating companies. This means that the 305 directors not connected with the managing agency firm in either a working or prestige capacity held only 387 directorships. Thus, managing agency directors held an average of 4.7 directorships in the controlled companies and prestige directors held an average of 2.5 each. On the other hand, nonagency and nonprestige directors held only 1.1 directorships per man.

The above statistics, of course, do not answer the crucial question concerning the distribution of authority among agency and nonagency directors on the various boards of the operating companies. Yet, they suggest that the agency directors occupy strategic positions within the operating companies and are in a position to influence greatly the decisions made in those companies. Consequently, this author is prepared to argue that in nearly all operating companies in India, British and Indian, the role of directors performing independently of

managing agents—or in opposition to them—is most infrequently met with. The managing agency firm dominates the board of directors in the same way that it dominates all other aspects of enterprise in the modern sector of the Indian economy.

CONCLUSION

The conclusions reached by the author in this paper have been set forth at the end of each section. These will simply be summarized here for convenience. It is argued that the managing agency system of industrial organization is the result of efforts by British and Indian entrepreneurs to overcome the limitations imposed by a shortage in India of venture capital and business ability. The managing agency firm must be considered the heart of the system, for the legally separate joint stock companies in which the producing and trading activities of managing agents are carried on are, in fact, simply operating arms of the key unit—the decision-making agency firm. Although the data supporting this conclusion are not very voluminous and come from varied sources, the author thinks the information is sufficient to outline the major contours and behaviour patterns within the system.

One area of current discussion of the managing agency system has not been touched on here. That is the nature of criticism which is frequently levelled at it by various persons—many of them highly-placed in government, law, journalism and economics. Most of these censures are directed at the manipulations and transgressions indicated in the body of the paper. Some of the proposed reforms strike at the entire system even though the evidence used to show why they are necessary relate only to the shortcomings of specific managing agents. Whereas the acts of irresponsible agents receive the most publicity, the achievements of those who use the system as an instrument of much-needed development go unheralded.

The whole question of the managing agency system was studied recently by a company law committee appointed by the Government of India. The lengthy report of the committee boiled down to a set of specific recommendations to remove some of the more obvious opportunities for wrong-doing by

agents. These were mainly technical recommendations and need not be discussed here. The Central Government still has the subject under consideration, and will probably legislate a new company law in the near future. Nevertheless, it is doubtful whether the fundamental character of the managing agency system will be changed. For this reason, the author thinks the system is an institution worthy of further study by those interested in economic development in India.

8

The Managing Agency System*

This extract from the Patel Committee Report contains a useful analysis of the general problems of promotion, financing and management of industrial undertakings in the particular circumstances of India and against the background of wider social objectives. It pays special attention to the question of entrepreneurial motivation under alternative forms of management. The extract is noteworthy from another viewpoint: while earlier criticisms of the managing agency system were mostly concerned with a description of managerial malpractices, the Patel Committee's concern was whether the managing agency system was at all needed from the functional angle. For this reason, it is of more than historical interest.

Editor

MANAGING AGENCY—PRO AND CONTRA

The managing agency system is the peculiar product of long historical evolution in this country and has assumed, therefore, a number of distinct forms at different stages of its development. Even today, the managing agency system as it exists in the country represents a large number of typical situations which need to be distinguished one from the other for analytical convenience. Some of the important

*Taken from the *Report of the Managing Agency Enquiry Committee*, New Delhi: Government of India, Department of Company Affairs, 1966, pp. 6-16 and 43-48. The Chairman of the Committee was Dr. I.G. Patel. Reprinted by permission.

types or stages may be distinguished as follows—

(i) Members of a family and their friends pioneer a company and constitute a partnership firm to manage the company as managing agents and continue to have a considerable involvement—both emotional and financial—in the affairs of the company and take a great deal of personal interest and risk in the development of the company.

(ii) After a period of initial progress, the company becomes more or less established; and with the passage of time, the partnership rights in the managing agency are either passed on by inheritance to a growing number of people or are sold to persons and families initially unconnected with the company. At this stage, the managing agency becomes almost indistinguishable from inherited wealth, which gets shared in a routine manner by successive generations of the expanded joint family and their friends. The personal involvement, if any, in the affairs of the company applies only to one or two of the individuals in the group, whose share in the 'property' may be quite small.

(iii) Sometimes, the pioneers of a company or their successors prove more dynamic so that in course of time, they pioneer four or five companies. Under these dynamic conditions the managing agents require a growing volume of resources and often convert themselves from a partnership to a private or a public limited company. In course of time, the share capital of the companies, as also of the managing agency firm, gets more widely distributed by inheritance or otherwise and the active management of the managing agency (and of the managed companies) comes to rest with a few persons, who may or may not be connected with the original founding family. Sooner or later, the managing agency firm acquires an essentially professional or bureaucratic character, although a large number of persons receive an essentially 'unearned' share in the profits of the managing agency firms.

(iv) A private or public limited managing agency firm might also continue to maintain its dynamism without giving up its closely knit family or community character and it may acquire management rights over a number of companies by withdrawing its investment in one company to acquire control over another or by investing its managing agency and trading profits in other companies, whether new or established. In that case, a considerable time—spread over generations—will elapse before such a managing agency will acquire an essentially public (i.e.. non-family or non-communal) and bureaucratic character. Before this transpires, however, the managing agency house or group would have acquired a large degree of economic power out of proportion to the wealth or investments of the active members of the group.

(v) Sometimes, a number of medium-sized managing agency companies or houses which have lost their dynamic momentum might combine to set their respective houses in order. Alternatively, in an industry experiencing difficulties, a number of units might combine together with a corresponding merger among their respective managing agents. The process of amalgamation would create a vast and powerful complex of companies, which would be quite capable on its own of running its affairs and of employing highly skilled technical and managerial personnel. Nevertheless, the historically constituted managing agents would continue to claim their share in the profits of the managed complex.

The distinctions that we have drawn above about the stages and types of managing agents are necessarily in general terms. They are, however, intended to bring out the fact that the managing agency is not something uniform or homogenous. It is this fact which gives an air of unreality to many arguments regarding its continuance or discontinuance-arguments that start from a particular image of the managing agency which is by no means universally applicable. It is this diversity again which makes it difficult to arrive at a judgment about,

the likely consequences of the continuance or discontinuance of the system, unless it so happens that in specific industries a particular stage or type of the managing agency system assumes a representative character.

Reference has been made more than once before to the desirability, other things being equal, of abolishing the managing agency system on wider social and economic grounds, and it would not be out of place to mention these larger considerations in brief. There are primarily two considerations that argue against the managing agency system, viz., that it makes for undue concentration of economic power and that it inhibits the growth of a professional managerial class and the emergence of greater vertical mobility among those with talent, who do not enjoy business connections as an accident of birth. Concentration of economic power is a complex phenomenon, which derives its strength from a number of deep-seated causes and is not, therefore, likely to get materially reduced in strength by action on any single front such as a change in the form of management of companies. To a certain extent, concentration of economic power may even be unavoidable or desirable in an economy which relies heavily on private enterprise. The accent of policy, nevertheless, has to be on discouragement of concentrated economic power, particularly when it is unrelated to the performance of corresponding economic functions and when it threatens to get entrenched for reasons of privilege or birth. The managing agency system can serve—and has served—as a vehicle for concentrating economic power beyond what would be justified by ownership wealth. Given the hold of a few business houses in Indian private industry, their actual control over the affairs of the companies managed by them is not likely to be reduced materially in the short-run by a change in the form of management. But over a period, the discouragement of the manging agency system cannot but have a salutary effect in preventing undue concentration of economic power.

As for the other and related larger consideration mentioned above, there is no doubt that equality of opportunity in business management and the growth of what might be called a secular and professional class of business managers would be greatly facilitated by the gradual abolition of the

managing agency system. In law, managing agency rights are not hereditary. But in practice, the son of an important member of a managing agency firm or house will inherit the position of power from the father, either by inheriting the share of the managing agency company or by being accepted as a partner. The managing agency system in large part is the manifestation of the caste system and of communal and family exclusiveness in the sphere of management. Admittedly, a particular managing agency, as noted earlier, might reach a stage where it becomes indistinguishable from a firm of professional management consultants. Equally, in a family firm, entry for outsiders would be difficult irrespective of the form of management. But with the growing need for and emphasis on management training in the country, it has become more urgent to slacken the hold of the managing agency system on available management opportunities

Reference is often made to the potentiality for misuse of the managing agency system. We have not given much weight to this consideration as misuse and mismanagement are difficult to determine except on a detailed examination of individual companies—which is not within the purview of our enquiry. There is also force in the argument put to us by some of the parties that have responded to our questionnaire, viz., that control over misuse and mismanagement is the appropriate function of the Company Law Board, which is entrusted with the day-to-day administration of the Companies Act. Given the wide powers that the Government already enjoys for regulating the activities of managing agents, the case for the total abolition of the system in an industry cannot rest on a presumption of general mismanagement or misuse.

The crucial question is that of the contribution of the managing agents and whether a similar contribution could be assured for the companies and for the industry in future under an alternative form of management. There seems to be general agreement that this contribution lies essentially in the (a) promotional; (b) managerial; and (c) financial sphere of the activities of the managing agents.

PROMOTIONAL CONTRIBUTIONS

Broadly speaking, new companies are promoted either by persons and groups who are relatively new to the industrial field or by business groups and companies already well established. Somebody certainly has to spend time and money in working up a new business proposition; and it is perhaps desirable that a group of resourceful persons relatively new to the industrial field should not be left with no alternative but to 'sell' their promising propositions to established groups with money for a fee. It is perhaps also understandable that new entrants to industry might wish to have an intimate association with the companies they help to promote. But in the case of true promoters of this kind, the desired form of association with a new company can be adequately provided by a managing directorship or a place on the Board of Directors. Even assuming that in exceptional cases a managing agency form of management might facilitate the marriage of true promoters with sizeable financial participation, there is no reason why a managing agency should be necessary or justified for anything longer than the initial period of growth. After that, even promoters and financiers should be content to earn the normal return on investment plus remuneration for the actual amount of management time and resources provided.

Where the promotion of a new company is undertaken by business houses or companies already well established, the only question is whether in the absence of the managing agency system, there would be sufficient incentive for expansion or for branching out into new spheres of activities. Where the motive for expansion or for branching out into new spheres of activity is the desire to invest surplus funds or to respond to competitive considerations or simple dynamic urge, the available form of management would make little, if any, difference to the scale of promotional activity undertaken. The Board of Directors form of management could assure sufficient prestige and essential contact with the management of the companies a group has helped to establish. Over time, the companies themselves will acquire the image in the public mind which is now enjoyed by the managing agents so that further promotion by companies should receive as much public response as is now supposed

to be elicited by managing agents. Even today, there are many managed companies which are better known than their managing agents.

It is also noteworthy that in the promotion of new companies in recent years, particularly in the newer industries, the role of managing agents has not been important. Of the total number of non-government companies formed during 1956-65, only 1.5 per cent were managed companies, while the remainder were not managed by managing agents. In terms of authorised capital, the share of the managed companies was only 1 per cent in the total.

MANAGERIAL CONTRIBUTION

It has often been claimed that the distinctive managerial contribution of the managing agency system lies in the fact that it provides advantages of group management. Here again, it is necessary to distinguish between the different types of managing agencies. It will be seen, for example, from Table 8.1 that the vast majority of the managing agencies in the country (about 92 per cent) managed only one or two companies each. In their case, the so-called advantages of group management are clearly irrelevant. Indeed a managing agency, where the income is shared by a large number of people by reasons of inheritance while the active part in management is taken by one or two persons, often comes in the way of adequate incentives for management. Since income from management has to be shared among a large group of people for historical reasons, the active partners are denied their proper remuneration. This state of affairs is likely to lead to indifference, if not mismanagement, so that replacement of managing agents by one or two managing directors would establish better correspondence between responsibility and reward.

The situation in a large managing agency or business group, which manages a large number of companies, presents a different set of problems. Here, there is considerable force in the argument that economies of group management can take place. Whether the economies exist in all actual cases of this sort or are passed on to the companies is not so self-evident.

TABLE 8 1

STRUCTURE OF MANAGING AGENCIES AS ON 31ST MARCH, 1965

(Paid-up capital in lakhs of Rs.)

No. of companies managed by each	*No. of managing agents*	*No. of managed companies (col. 2 multiplied by col. 1)*	*Paid-up capital of managed companies*
(1)	(2)	(3)	(4)
1	713	713	19,394
2	73	146	5,436
3	24	72	3,299
4	13	52	1,611
5	13	65	1,748
6	5	30	6,173
7	6	42	2,756
8	5	40	4,574
9	4	36	1,276
10	4	40	5,617
Total	860	1,236	51,884

Source—The Ninth Annual Report on the Working and Administration of the Companies Act, 1956 published by the Department of Company Affairs and Inserance.

In many cases, even large managing agents managing a vast complex maintain hardly any organisation of their own and the managing agency commission bears no relation to any reasonable remuneration for the people actually employed for servicing the managed companies. The practice is also not uncommon of charging the managed companies separately for almost every specific service rendered, so that one would be hard put to enumerate the remaining services, which can justify the managing agency commission. Also, a more or less hereditary group of persons managing a large number of companies does not necessarily make for flexible, responsive, competent and efficient management so that the group diseconomies may be as common as group economies.

Over time, it should also be possible to retain the advantages of management in the event of abolition of the managing

agency system. Many services at present provided by managing agency firms on a group basis to several firms could well be continued to be supplied by charging a fee. Such services may include legal advice, advice on income-tax matters, legislation and economic trends in general. In due course, one may also expect the development of professional management consultancy firms, which might render managerial services to those who pay for them, irrespective of past association or commitments regarding long-term or perpetual association in future. Some of the large managing agencies, which have already reached a mature and impersonal stage. can well convert themselves into management service companies without delay and without disbanding or retrenching their present organisation. Eventually, there might be increasing specialisation among managing consultancy firms either industry-wise or service-wise.

In short, the advantage of group management prevails at present over only a limited area covered by the managing agency system. Even where a managing agency firm manages a large number of companies, it cannot be taken for granted that economies of group management prevail or that they are reflected in the profits of the managed companies rather than in the profits of the managing agency firm. In the long run, economies of group management could also be assured more satisfactorily by the development of management consultancy firms. While, therefore, there might be some cases, where genuine advantages of group management might be disturbed in the transitional period, there is not much force in the argument that, taken as a whole, the managing agency system provides substantial and irreplaceable advantages of group management.

FINANCIAL CONTRIBUTION

We turn now to a consideration of the financial contribution of the managing agents. This is a problem with many facets and we shall deal with some of the important aspects here in general terms.

TABLE 8.2

SOURCES OF CORPORATE FUNDS

(*Rs. in crores*)

Sources of Funds	1951-55		1956-60		1961-64	
	Amount	*% to total*	*Amount*	*% to total*	*Amount*	*% to total*
1. Paid-up capital ..	31	7.0	120	10.8	117	11.2
2. Reserves and surplus	102	23.0	194	17.4	162	15.5
3. Provisions ..	173	39.1	310	27.8	353	33.7
4. Borrowings—						
(*i*) From Banks ..	26	5.9	181	16.2	154	14.7
(*ii*) From Statutory Financial Corporations	25	5.6	9	0.8	10	0.9
(*iii*) From others by way of debentures, mortgages, etc.	7	1.6	102	9.1	32	3.0
5. Trade dues and other current liabilities ..	16	3.6	167	15.0	151	14.4
6. Miscellaneous non-current liabilities ..	47	10.6	4	0.3	(—)1	..
7. Other sources: loans from managing agents, fixed deposits, etc.	16	3.6	29	2.6	69	6.6
Total ..	443	100%	1116	100%	1047	100%

Source—Reserve Bank of India Bulletins (September 1957, June 1962 and November 1965).

Note—The coverage of the three RBI Studies in terms of number and paid-up capital of companies included in the Studies is indicated below:

Study	*No. of companies*	*Percentage of paid-up capital covered*
1951–55	750	66
1956–60	1,001	78
1961–64	1,333	79

The above table based on Reserve Bank's survey of non-financial non-government companies reveals a number of

interesting things. Internal resources of companies form by far the largest source of company finance. The significant role of financial institutions is also clearly evident. These two sources should become even more important in view of the growth of financial institutions since 1962, greater governmental support to these institutions and a wide variety of tax concessions offered in the last Budget to encourage expansion and repayment of institutional loans. By comparison, paid-up capital and loans from managing agents and deposits from private parties play a rather limited role. There is no doubt that the very substantial growth of the corporate sector and of financial institutions over the past decade and a half has made corporate finance increasingly independent of the managing agents and their friends.

The above picture relates to the entire corporate sector and does not tell us much about the possible role of the managing agents or their friends at the time of the formation of a company. We have already noted the marginal role of the managing agents in recent years in the promotion of new companies. Clearly, for smaller companies, a group of persons and their friends might still play an important part in putting up the initial finance. But this need not be deterred, as we have noted earlier, as long as the initial promoters and financiers can claim a proper share in management as Managing Directors or as Directors on the Board. Despite the increasing role played by the L.I.C., I.C.I.C.I., I.F.C., Banks and the Investment Trusts in providing initial loans, as well as underwriting functions, the part played by brokers and individuals in underwriting new shares is still sizeable; but the contribution that can be attributed directly to managing agents is negligible (cf. Table 8.3). In any case, the real point is that the willingness of promoters to stake their money initially is not so dependent on their being associated with the company as managing agents and nothing else. Equally, with growing diversification of the economic structure, most new companies require such large amounts of funds, that support of particular groups of individuals can form only a small part of total needs. The real support comes from institutions, the general public and other companies.

We have already noted that direct loans from managing

TABLE 8.3

UNDERWRITING OF CAPITAL ISSUES DURING 1963-64 AND 1964-65

(*Rs. in lakhs*)

Underwriters	1963-64 *Amount under-written*	1963-64 *Percentage to total amount under-written*	1964-65 *Amount under-written*	1964-65 *Percentage to total amount under-written*
1. Life Insurance Corporation of India	480	19.2	985	22.9
2. Unit Trust of India ..	..	..	555	12.9
3. Industrial Credit and Investment Corp. of India ..	287	11.5	515	12.0
4. Industrial Finance Corporation	238	9.5	435	10.1
5. State Finance Corporations..	233	9.3	396	9.2
6. Banks	359	14.3	296	6.9
7. General Insurance Companies	106	4.3	247	5.7
8. Industrial Development Bank of India	..	..	106	2.5
9. State Governments ..	73	2.9	57	1.3
10. Investment Corporation of India	46	1.9	26	0.6
11. Brokers	630	25.2	654	15.2
12. Others including Managing Agents, Foreign Collaborators, etc.	50	2.0	30	0.7
Total ..	2502	100.0	4302	100.0

Source—Company Law Board.

agents form only a small part of total corporate finance. Nevertheless, in view of the immediate impact on managed companies from any sudden withdrawal of such loans, we have given special attention to this aspect in the individual industries studied by us. It has been suggested that private deposits with companies—which have grown in recent years—might be withdrawn in case of the discontinuance of the managing agents. We are unable to accept this suggestion as many non-managed companies also attract large private deposits. Where the deposits

are attracted by the special influence of managing agents, the terms offered at present are not likely to be relatively unremunerative so as to make for a sudden withdrawal.

The practice of the managing agents giving guarantees for both long-term and short-term loans obtained by managed companies from financial institutions has been emphasised by most of the companies responding to our questionnaire. This practice is rather peculiar to India and represents a hang-over from private money-lending practices as well as a symptom of the close ties that exist in India between the banking system and leading industrial houses. Normally, most of the needs of an industrial company for short-term finance should be for purposes, which should be thoroughly bankable in the sense that they would offer scope for giving the necessary security in kind. Personal guarantee, even when sound, can be the source of speculative abuse so that the replacement of the personal guarantee of managing agents by the security of stock-in-trade, warehouse receipts, goods in transit, etc., for short-term loans would represent a welcome move both towards sounder banking and sounder financial management for companies. The fact, however, remains that not all the needs of working capital can be met by hypothecation of stocks, etc. In part, and in the case of a new company, the requirements of working capital, which cannot be obtained as a secured loan can be provided for in the initial capital structure. For an established company, reserves can also meet a part of the need. Indeed, even unsecured bank loans should be based more on a cash flow analysis of the companies rather than on the personal guarantee of individuals. While we would welcome the development of the Indian banking system on these desirable lines, the banks today almost invariably insist on personal guarantees—which are given by managing agents in the case of managed companies and by Managing Directors or/and other directors in the case of non-managed companies. If the managing agency system is terminated, the banks would presumably insist on getting guarantees from Managing Directors and other Directors—an insistence, which cannot but create difficulties when the Managing Director, for example, is a professional person. While recommending a departure from the present practice of insisting on personal guarantees for bank loans, we cannot dismiss the fear of some

transitional difficulties in this regard in the event of the abolition of the managing agency system.

Guarantee for long-term loans by managing agents in addition to the security or mortgage of the company's fixed assets is also a common practice that has grown historically and even institutions like the I.F.C. (but not the I.C.I.C.I.) have come to require such guarantees in several cases. We had discussions, however, with the management of the I.F.C and we understand that they do not anticipate much difficulty in regard to guarantees now in force or their future operations in the event of the abolition of the managing agency system in an industry It was explained to us that the I.F.C. has obtained personal guarantees in the past from both managed as well as non-managed companies. Their main justification, it would appear, for obtaining personal guarantees is that they like to determine where responsibility lies in ensuring that the obligations assumed by the company are being fulfilled. Such a determination, however, does not necessarily require the existence of a managing agent. We, however, hope that financial institutions will find it increasingly possible to move away from the practice of requiring personal guarantees as distinct from judgments based on the soundness of the purposes for which they gave financial assistance. Unless this is done, some transitional difficulties in the event of the abolition of the managing agency system cannot be overlooked particularly, where the new form of management would be in the hands of professional Managing Directors.

Briefly, while the financial contribution of the managing agents is not generally as important as is often asserted, it has to be recognised that the abolition of the managing agency system in an industry might create financial problems for some time for some of the units. It would be advisable, therefore, for the Government to make some provision through an appropriate financial institution to help out genuine cases of distress or dislocation in a fairly flexible manner.

In conclusion, our general survey of the advantages and disadvantages of the Managing Agency System would suggest that many of the advantages claimed for it are exaggerated at least in the context of established industries. At the same time, it would be equally true that in the present context, where a

great deal of supervision over the operation of the Managing Agency System is exercised by the Company Law Board, many of the so-called disadvantages of the managing agency system are also exaggerated. The one real disadvantage that we see in the continuance of the managing agency system is that, in the long run, it comes in the way of the establishment of what might be called a professional managerial class based on talent rather than on birth. This is not to deny that there are many managing houses which have begun to open their doors to talented people without any family connection. Nonetheless, the process of creating a growing class of managers drawn from a wide section of society would be facilitated by discontinuance of the managing agency system wherever it can be done without harm in the short run.

We should add, however, that the whole question of the discouragement of the managing agency system deserves to be considered as a measure of reform which has effect over time, rather than as a much-needed surgical operation, which restores health and vitality in a short span of time. Much of the fervour that gets attached to pleas for its continuance or discontinuance is based on rather exaggerated notions of the advantages and disadvantages that are likely to ensure both from its continuance as well as from its discontinuance. It is for this reason that transitional consideration of the nature and magnitude of the dislocation and disturbance that might be caused in the short run are of as much relevance as the so-called basic or inherent advantages or disadvantages of this system. In our judgment, the course of policy should be clear, namely, set towards the discourgement of this system. The pace to be set for the policy, however, should be a measured one as nothing very vital is likely to be sacrificed by hastening slowly in this field.

* * *

ALTERNATIVE FORMS OF MANAGEMENT

The future of the managing agency system cannot also be considered except with reference to the alternative forms of management. Under the Company Law of 1956, three alternatives to the managing agency system are possible, viz.,

Secretaries and Treasurers, Managing Directors and a Board of Directors with or without a Manager. At one time, the institution of Secretaries and Treasurers was thought of as a suitable alternative to the managing agency system. In point of fact, however, it has not proved attractive to all but a handful of new companies formed in recent years. It would be no exaggeration to say that for all practical purposes, Secretaries and Treasurers exist only in those cases, where managing agents already in existence had to shed some of the managed companies in view of the limit of ten on the total number of companies that a managing agent can manage. The companies so shed continued in most cases to be managed by their erstwhile managing agents as Secretaries and Treasurers.

It is not unreasonable to assume that, in the absence of deliberate policy to the contrary, the termination of the managing agency in the case of important managing houses will simply lead to their replacement as Secretaries and Treasurers. We cannot see in such a change any particular gain and would like the Government to consider carefully whether managing agents should be allowed automatically to be replaced by Secretaries and Treasurers. Apart from the fact that Secretaries and Treasurers can draw a maximum remuneration of 7½ per cent of net profits (as against 10 per cent for managing agents) and are not permitted to nominate their representatives on the Board of Directors, there is hardly any difference between them and managing agents. Indeed, unlike in the case of managing agents, there is no limit on the total number of companies that a firm or group can manage as Secretaries and Treasurers.

As for Managing Directors, under present legislation, a company can have up to two Managing Directors each of whom can claim a maximum of 5 per cent of the net profits of the company as remuneration. No person can be a Managing Director in more than two companies so that this form of management makes for diffusion of managerial responsibility among a wider circle and reduces the danger of absentee managers collecting a continuing royalty for services rendered in the past (often by ancestors). The formula of sharing in profits affords both compensation for risks taken earlier (as promoters as well as incentive for continuing attention to the

efficiency and growth of the company. Thus, this form of management combines some of the advantages of the managing agency system without its disadvantages. However, it is also pertinent to ask whether in every case that a managing agency is terminated, two Managing Directors should be permitted and each allowed the maximum remuneration of 5 per cent of net profits. In that event, the cost of management to the company would be the same as in the case of a managing agency with privilege attached to a few persons only. We should think that in approving managing directorships and their remunerations, due regard should be paid to qualifications and the kind of remuneration which cannot be considered too extravagant for the services of any one person.

It was also represented to us that in view of the suspicions attaching to the managing agency system in the past, the present company legislation provides a number of checks on the powers of managing agents. The legislative checks on the powers of the managing directors, however, are not so comprehensive. We were told that if the managing directorships were to be a more predominant form of management, the question of limiting their powers, prescribing their qualifications, defining their remuneration, etc., must be reconsidered carefully. We feel there is substance in this point of view and would suggest a careful examination of it. In particular, we feel that the right of managing director or his associate to receive remuneration as selling agents or purchasing agents should be circumscribed in the same way as in the case with managing agents. In the ultimate analysis, the managing agency system—at its worst—is a device for siphoning off a part of profits from a company and sharing it within a small group. If the same result were to be permitted through selling or purchasing agencies given to a privileged group, we would be exchanging simply King Log for King Stork. This whole question of policy towards selling and purchasing agencies, therefore, also needs to be considered carefully.

Sooner or later, the gradual elimination of the managing agency system (without its replacement by Secretaries and Treasurers) will transform the nature and *modus operandi* of the leading business houses in the country, which exercise their control at present essentially through managing agencies

controlled by them. It is in the nature of economic power to seek to perpetuate and extend itself in one way or another. To some extent, this will be done by interlocking directorships as well as through socially interesting phenomena such as dynastic marriages to bring within one family umbrella as many 'natural' managing directors as possible. Substitutes for the present form of control, however, will also be sought in many other ways unknown or unfamiliar today such as amalgamations, holding companies and the like so that the lineaments of new but equally pervasive and inbred managerial alignments will have to be defined and dealt with continuously. We mention this only to underline that in matters such as concentration of economic power or perpetuation of economic privilege, there is no such thing as the end of the road in a growing and mixed economy.

Finally, policy in this regard must also have a positive aspect. Training of larger and larger managerial cadres from all walks of life, encouragement to management and other consultancy firms through fiscal and other devices, a purposeful deployment of the financial resources of governmental and semi-governmental institutions and the weaning away of banks and other financial institutions from the practice of obtaining personal guarantees are all aspects of a positive approach. The debates during the enactment of the Companies Act of 1956 showed a great deal of concern lest the termination of the managing agency system should create a vacuum. The danger now of a vacuum being created is less. But it is by no means non-existent. Continued vigilance, therefore, has to be matched by continuous attention to the genuine needs of industry for finance, know-how, counsel and intelligent risk-taking.

Commercial Banks and 'Banques d'Affaires'*

Lord Piercy

This paper surveys the post-Second World War trends in the theory and practice of commercial banking. The author points out that in bank lending no clear line can be drawn between the provision of credit and the provision of capital. Since stocks and work-in-progress are elements of capital formation, the banks do provide their customers with capital year after year even though bank credit is nominally regarded as short-term in character. He notes that since the Second World War, the banking systems have fairly generally been expected to do more for financing the capital formation of industry than the orthodox views on deposit banking would allow.

Editor

Relations between bankers and industrialists vary a great deal from one country to another. They have undergone far-reaching changes in the course of recent financial history, especially after the depression of the 1930's and, again, since the Second World War.

Differences in the structure of banking systems in the

*Taken from O.E.E.C. (now OECD), *The Supply of Capital Funds for Industrial Development in Europe*, a report prepared by Lord Piercy in collaboration with National Consultants, Paris, 1957, pp. 19-22 and 39-40. Reprinted by permission.

methods and traditions of banking, and in the policy of governments in this field, are so important in their effects, that there would be no point in attempting a general international comparison of the resources of a capital nature provided by the various banking institutions in the group of countries covered by this study. What is attempted here is a consideration of national arrangements separately, by type of institution, with comparisons wherever this appears relevant.

For the purposes of our analysis those credit institutions which receive moneys on current or deposit account and lend out their resources in the form of bank credit will be considered as commercial banks. By bank credit is meant loans and advances expected to be repaid within relatively short periods, when the purpose of the borrowing has been achieved.

This definition does not completely fit actual banking practice. It does not describe in particular advances on current account (overdraft in British terminology). Overdrafts serve to finance a flow of transactions and consist (or should consist) of continuous drawings and repayments. They can, however, be terminated at short notice by the lending bank, and this places them in the category of short-term credits. The principle that commercial bank credit should be repaid when it had achieved its specified objects, and that each loan should be made as a separate, terminable transaction between banker and customer, underlies the present-day practice in the United States and operates to exclude overdrafts from commercial bank lending. But it is far from being generally recognised as a guiding principle in other countries.

The controversy as to the proper scope and conditions of bank credit has never been settled. It came to a head during and after the world-wide crisis of the early 1930's, when it became evident that enormous amounts of bank deposits were solidly tied up in loans and investments that could not be turned into cash quickly enough to repay millions of depositors wanting their money back. Most banking sytems underwent more or less drastic reforms enforced by law. The outcome was that deposit banks were subjected to various safety rules as to liquidity, length of credit, degree of direct risk assumed, etc., and *banques d'affaires* were no longer allowed to receive deposits.

The essence of a *banque d'affaires'* business as distinot from so-called depoist banking in England, is that its lending is not confined in principle to self-liquidating credits but includes long-term financing of industry and trade, promotion of new issues of capital, and nursing substantial holdings of shares or bonds over long periods. This involves rather intimate relations with industry. *Banques d'affaires* sometimes have permanent interests in industrial companies, and take an active part in their management and development. They make special arrangements with other institutions or persons (consortium agreements) for financing and administering extensive industrial projects, and do a great deal of under-writing and 'placing' business in the capital market.

It can be argued that the distinction between provision of credit and provision of capital is, in terms, illusory; though this is not the position taken by practical bankers. One of the commercial banks' essential functions, universally recognised as such, is to supplement their customers' working capital by lending them the additional funds needed for financing stocks, work-in-progress, debtor accounts and exports until the proceeds of sales are collected. Apart from the case of industries whose sales are of a highly seasonal character, bank advances do not show very wide fluctuations at times of reasonably good trade, as long as the borrowers are reasonably proficient. For all practical purposes the bank's money becomes a part of the borrower's working capital over periods of considerable length, particularly under conditions of expanding and profitable business. It is not always possible, nor would it be desirable, to finance increases in stocks and work-in-progress by corresponding increases in the permanent capital or long-term borrowing of industrial firms, or to invest in this way most of their retained profits.

Since stocks and work-in-progress are elements of capital formation it is clear that the banks do provide their customers with capital year after year, and that in spite of the conventional views on the short-term character of bank credit, throughout the normal life of industrial firms, much of their working capital is their banker's money. And when the banker allows, and helps, his industrial customer to use his retained profits for buying fixed assets instead of repaying his overdraft, he

may be said to be taking to that extent an active part in his customer's fixed capital formation. This has been the policy widely followed by the commercial banks in many countries in the post-war period. The rapid industrial recovery and steady rise of production throughout this period would not have been possible had the bankers acted otherwise.

It cannot be denied, however, that, apart from its implications for the depositors, lock-up lending by the commercial banks can be harmful to the industrial borrowers also. The best safeguards are those in vogue in countries like England, where, in principle anyhow, bank loans and overdrafts are kept, in volume, well within the customers' requirements of working capital: requirements, that is, for financing stocks and debtors, and loans are not made for financing fixed capital expenditure, unless in view of an early issue of capital for repaying them. Notwithstanding such safeguards, in times of bad trade and falling prices bankers get easily alarmed and are apt to press for repayment in circumstances that may involve their industrial customers in further heavy loss, and so start a snowball process with the well-known effects on the whole economy.

Changes in the nature and composition of bank resources since the 1930's may seem to have made the recurrences of widespread panic less probable. The ratio of time-deposits to total deposits appears now to be higher in many countries where considerable amounts of institutional moneys and unused business reserves are left with the banks for fixed periods of up to 2 or 3 years and even longer. After tribulation of many kinds in the last quarter of a century, the saving public in Western Europe may have become less impressionable, more confident in the strength of institutions which have withstood the impact of calamity and continue to do their work efficiently and profitably. The concern of governments about depositors' interests, and the measures taken in the recent past to protect them, may well have led many people to expect that the authorities would act without delay if emergency came again, and that their action will be effective.

There is some plausible ground for such expectations in the fact that a considerable part of the bank deposits in all countries is tied up now in government securities and loans to public authorities. As recent events demonstrate, banks are

most likely to sell this part of their assets for cash in a liquidity crisis, and it is hard to imagine that the authorities would allow the banking system of any country to run into serious trouble in meeting depositors' drawings as long as the bankers' investment in public securities remained amply sufficient to meet these drawings.

It is probable, though hard to prove statistically, that for psychological as well as structural reasons there is a hard core of bank deposits which is not likely to be severely affected by a sudden rush into liquidity. Relying on this assumption, and also on their own resources in capital and reserves, and on the extensive facilities for 'mobilising' assets through the central banks, some commercial banks seem to consider as justified the use of part of their deposits for long-term loans to industry. They have been and still are, urged to do so by business people and by writers on finance and investment. There is a distinct trend of opinion in that direction, especially in favour of assisting with capital industrial firms with no access to the capital market. Any extensive development in this sense would in effect be reversing the continental banking reforms of the 1930's.

A safer and convenient method of using the commercial banks' resources to the proposed end is to form specialised, technically well-equipped institutions whose share capital is jointly held by the banks, and to supply them with sufficient loan capital for long-term investment. One advantage of this course is that it defines the extent of the banks' engagement. It is essential that the loan capital provided should be really earmarked for long-term lending and not withdrawable whenever the shareholding banks have liquidity troubles. A technically safer solution is for any such specialised institutions to raise their operating funds by issue of bonds and debentures, instead of relying on bank advances. This might still leave to the banks the function of supplying the basic capital.*

* * *

The significant trends in the banks' activities since the

*A solution on these lines was recommended to Austria by a committee of international experts but was rejected on political grounds.

end of the war may be summed up as follows :

(i) Deposits have been rising in every country. In the light of the information available the proportion of time-deposits to demand-deposits appears to be higher than it usually was before the war. The general outlook on deposits may be changing; they seem to be considered as less subject to mass withdrawal than they were in the 1930's.

(ii) On grounds of orthodox banking principles this is thought, in some countries, to justify the very substantial provision of industrial finance by the banking system on medium- and longer-term since the end of the war. Far more potent factors have been the urgent and massive demand for industrial capital, the slow recovery of the public capital markets, the general inflationary state of national economies, and cheap money policy where it was applied.

(iii) In bank lending no clear line can be drawn between provision of credit and provision of capital. By financing stocks and work-in-progress, and by supplying intermediate finance in anticipation of capital issues by the borrowers, the banks have been supplying industrial capital on a larger scale than is revealed by the statistics available.

(iv) The issue of *bons de caisse* by Belgian banks as a method of collecting medium-term funds, and the similar device of *Schuldverschreibungen* in West Germany, point to yet another way to expanding the role of the banks in the supply of industrial capital. By investing part of their longer-term resources in industrial debentures, commercial banks (e.g., in Norway and Austria) are performing similar functions. The recent recovery of the public capital markets and the expansion of institutional savings seem to be favourable to the use of these methods on a larger scale: the banks' own issues of bonds and their holdings of debentures may be more easily turned into cash in wider and more active capital markets.

(v) By setting up specialised institutions for long-term lending to industry of resources provided by the commercial banks, significant results have been obtained (e.g., I.C.F.C. and F.C.I. in Great Britain, Mediobanca in Italy). This or similar methods may be tried in other countries, and the scope of such institutions may be expanded where they already exist.

(vi) It appears that *banques d'affaires* are recovering

much of the ground lost since the war. Adapted to the changed conditions they could play a technically most useful part in the supply of industrial capital in cases where deposit bank finance or the public capital market provide no direct solutions. So could the Belgian finance companies segregated from the large 'mixed' banks in the 1930's.

(vii) The use of central bank credit for medium-term finance by means of rediscount is being frowned upon for reasons that cannot be dismissed lightly. It must be stated, however, that in France this method has produced results not obtainable at the time by more orthodox methods. In other countries central bank rediscount is being used virtually for the same purposes, although this is not readily admitted. Taking a detached view of the potential inflationary effects of such rediscounts it might be worthwhile to probe deeper into the question whether these effects are likely to be more potent than those of the massive flow into some banking systems of treasury bills and government short-term bonds which on maturity are systematically replaced by new government securities of the same nature. Appreciable parts of such government issues are used to finance capital formation—in housing, nationalised industries, and public services.

(viii) It would be no overstatement to say that the banking systems are fairly generally expected to do more for financing the capital formation of industry than orthodox views on deposit banking would allow. It might be advisable to concentrate on devising newer techniques for solving the problems involved than to go on fighting a rearguard action against the trend of developments.

10

Bank Credit and Resources*

This extract from an IMF Mission's Report to the Indian Government discusses the problem of resources and policy of commercial banks in the context of development objectives. The paper points out that since there is a deficiency of real resources, a credit policy must be alert to ensure that a deficiency of money, as distinguished from a deficiency of real resources, does not further impede development and that whatever credit is made available through the banking system has the greatest possible effect in increasing production. The Mission was of the opinion that greater investment in the private sector, especially in moderate-sized industries and agriculture, may be exceedingly useful in developing production in India. Such producers have no access to the capital market and their need for additional funds can be met only through bank credit.

Editor

The chronic shortage of real resources even for a modest development programme, which is characteristic of underdeveloped countries, has led many businessmen and economists to advocate the expansion of bank credit to finance development.

*Taken from the article 'Economic Development with Stability', *IMF Staff Papers*, Vol. III, No. 3, February 1954. This paper is a report made to the Government of India by an IMF Mission which, at the request of the Government, visited India in February-March 1953. The members of the mission were Messers E. M. Bernstein (Director of the Research Department), Richard B. Goode, Morris Friedberg, and I. G. Patel.

Some have argued that, with the widespread underemployment of labour, no great impetus to inflation would result from the expansion of bank credit for investment to increase production. Others have recognized that such an expansion of bank credit would be inflationary, but argue that the harm done by inflation would be less than the harm done by continued economic stagnation.

UNDEREMPLOYMENT, CREDIT AND INFLATION

The view that the expansion of bank credit to finance development is not inflationary starts from the assumption that in underdeveloped countries a considerable part of the labour force is employed in low output work in agriculture. The contribution of such marginal workers to output may be exceptionally small in India because of the limited supply of land. The argument is that the transfer of such workers from agriculture to the construction of dams, roads, and other investments will result in little or no reduction in the output of food. And in time, the investment which is undertaken with their labour will increase the output of food and other consumer goods. The conclusion is then reached that for these reasons the expansion of bank credit to finance development would not be inflationary.

There is sufficient resemblance between this assumed case and reality to regard it as a satisfactory basis for analyzing the inflationary effect of the expansion of bank credit to finance development. If labour is taken out of agriculture and put to work on investment, the workers must be paid wages at a level not less than they earned in agriculture. If agricultural output is not reduced at all by the transfer of labour, then agricultural income will be the same as before. Thus aggregate incomes will be increased by the amount of the investment. With an increase in aggregate incomes, the expenditure on consumption will increase. By definition, there is no present increase in output of consumer goods, and prices will tend to rise.

The fact that investment results in increased production in the future is no assurance that the creation of bank credit to finance development will not give rise to inflation now. The

argument for this policy is based on a mistaken analogy between underemployment in underdeveloped countries and unemployment in industrial countries. In an underdeveloped country, the creation of bank credit to finance development will result in some increase in production of consumer goods in the future, but not sufficient to meet the increase in demand that will be generated currently. In an industrial country, the creation of bank credit to finance investment will result in a sufficient increase in production of consumer goods, if there is unemployment, to meet the demand that will be generated currently. Underemployment in an underdeveloped country does not indicate that other resources are available for a prompt expansion of the production of consumer goods. Unemployment in an industrial country does indicate that other resources are available for a prompt expansion of the production of consumer goods.

The question arises whether, at a later stage, when the investment results in a larger output of consumer goods, the same level of investment will also be inflationary. Suppose that after an interval of two years the effect of the new investment is to increase agricultural production *annually* by an amount equivalent to the additional investment financed by bank credit. Even under such circumstances, the maintenance of the same level of investment would generate inflation. The increase in output accrues as income to some part of the economy except as it results in additional tax revenue or is set aside as reserve for depreciation. While some of the increase in income will be saved, most of it will be spent. Thus, the larger part of the increased output is matched by increased expenditure. Only that part which remains as savings, taxes, or depreciation reserve is available to finance the new, higher level of investment.

MONEY SUPPLY AND ECONOMIC GROWTH

It must not be assumed that, because the creation of bank credit to finance development may lead to inflation, there is no positive or constructive role for an appropriate credit policy. On the contrary, because there is a deficiency of real resources, credit policy must be alert to ensure that a deficiency

of money as distinguished from a deficiency of real resources does not further impede development. And it must be alert to ensure that whatever credit is made available through the banking system has the greatest possible effect in increasing production.

As the economy of India develops, a gradual increase in the money supply will be needed. The increase in the money supply that will be necessary is likely to be not less than in proportion to the increase in production, and it may have to be somewhat more, if industry, commerce, and even agricultural production for the market gain in importance relative to agricultural production for the village community. Such an increase in the money supply is clearly not inflationary; and a smaller increase may prove to be inadequate for the needs of a stable economy.

There are only two ways in which the money supply can be increased: by the acquisition of foreign exchange assets and by the creation of credit. Under the traditional monetary systems, growth in the money supply was invariably linked with accumulation of gold or foreign exchange as a monetary reserve. Even with a more flexible monetary system, there is great merit in the basic principle that some addition to monetary reserves should accompany growth in the money supply. This is so because increased production is likely to be associated with an expansion of foreign trade and larger fluctuations in foreign exchange receipts and payments. That part of the growth in the money supply which is not matched by the accumulation of foreign exchange assets must arise from the creation of credit.

In India, it would not be desirable in the next few years to link the growth of the money supply with the accumulation of additional reserves. For a time, there will be a drawing down of sterling balances. At some stage in the future, the reserves will have been brought into appropriate relation with India's needs. Thereafter, it may become necessary to begin a gradual process of building up reserves to keep pace with the expansion of India's international trade and payments. The time when such a change in policy will be necessary is beyond the period covered by the Five Year Plan. For the present development programme, growth in the money supply will not be accompanied by any increase in monetary reserves; on the contrary, it will

have to be brought about in the face of a decrease in monetary reserves.

The provision of coins, including one-rupee notes, is undertaken by the Government of India through the Ministry of Finance. The supply of coins and one-rupee notes is determined by the needs of the public and the limitations established by law. For practical purposes, this is a negligible part of the broader means for dealing with the money supply. The effective force in the growth of the money supply is the action of the Reserve Bank of India in creating central bank credit and of the commercial banks in creating commercial bank credit. Changes in the cash balances of the Central Government do, of course, act to increase or decrease the supply of money held by the public, if not offset by other action. In the long run, however, there is little scope for significant changes in the cash balances of the Central Government, although at some times the Government may accumulate large balances and at other times it may draw them down rapidly.

The increase in the amount of money held by the public represents savings matched by real resources that go into investment. Where growth in the money supply is the result of the accumulation of foreign exchange, the investment is represented by the foreign exchange. Where growth in the money supply is the result of the creation of bank credit, the investment is represented by the projects financed by bank credit. The creation of bank credit within the limits of an appropriate money supply makes it possible for the public to hold enough of its savings in the form of money to assure price stability in a growing economy. The allocation of the bank credit among different borrowers affects the direction of investment arising from these savings.

DEFICIT FINANCING WITHOUT INFLATION

The Government of India is undertaking a considerable part of the investment for development. It is clear that current revenues and the proceeds of loans from the public, including commercial banks, will not provide sufficient funds to meet the requirements of the Government for its part of the financing of the Five Year Plan. The Government will, therefore, find it

necessary to draw down its cash balances and borrow from the Reserve Bank of India. The financing of the uncovered deficit in this way is called 'deficit financing' in India; and that is the sense in which this term is used in this report.

There has been a good deal of discussion of the significance of deficit financing in relation to the Five Year Plan. This discussion has ranged between two extreme views. On the one hand, there are some people who regard deficit financing as essential for the purposes of the Plan and a healthy means of stimulating enterprise. On the other hand, there are those who regard any deficit financing as inflationary and a serious threat to the stability of the economy. Deficit financing which is used to secure an appropriate money supply and to direct real resources to the Government for its investment is clearly essential to the success of the Plan. If deficit financing is undertaken without regard to its effect on the money supply and the availability of resources, it will inevitably lead to inflation and hamper the achievement of the Plan. Whether deficit financing is desirable or not depends fundamentally on the amount, the environment in which it is undertaken, and the policies that go along with it.

The first consideration in any policy involving deficit financing is whether there are inflationary pressures. If the economy is inflated, then deficit financing can only add to the problem. That was the situation in India some time ago and the public quite properly regarded the deficit financing of earlier years as a factor in this inflation. At present, however, available indices and the judgment of economists, businessmen, and bankers indicate that there are no significant inflationary pressures in the economy. Under such circumstances there need be no objection to deficit financing, provided the amount of such financing is limited to what is necessary for a sound credit policy, and provided other measures are taken to avoid excessive expansion of the money supply.

There is no formula by which one may determine the amount of deficit financing that may properly be undertaken in the near future. As in most matters involving credit policy, this is ultimately a matter of judgment. It may be assumed that the supply of money is now approximately suited to India's needs. A further contraction in the money supply is

not called for, unless there is a very sharp change in the payments position of India. The carrying out of the Five Year Plan will result in the drawing down of sterling balances. The process by which monetary reserves are used involves a diminution in the money supply equal to the decline in reserves, unless other measures are taken to offset it. As a minimum, therefore, the use of cash balances by the Government of India, and the creation of Reserve Bank credit and commercial bank credit, for the public and the Government, should be undertaken equivalent to the further use of sterling reserves.[1]

It is important to recognize the relation between deficit financing (or other credit creation) equivalent to the use of sterling reserves and the availability of real resources for the Five Year Plan. The use of sterling balances is already included in the estimate of real resources available for the plan. Deficit financing or other credit creation to restore the money supply does not increase the amount of real resources; it merely determines by whom the real resources should be used. To the extent that the money supply is restored by deficit financing or by government borrowing from the commercial banks, the real resources equivalent to the use of sterling balances are made available for the Government. To the extent that the money supply is restored by the borrowing of business from the commercial banks, the real resources equivalent to the use of sterling balances are made available for the private sector.

The expansion of the money supply, as distinguished from its restoration, does involve savings in the form of cash balances and, therefore, represents an increment of real resources for investment. So long as the expansion of the

[1]Creation of credit equivalent to the reduction of reserves attributable to a balance of payments deficit on either current or capital account is not inflationary and, indeed, is necessary to restore the money supply and thereby prevent deflation in a country in which the money supply is properly related to economic policy and the balance of payments deficit is an appropriate deficit that can be financed. In the case of a current account deficit, the credit expansion is necessary to match the additional supply of goods and services available from abroad and enables home investment to exceed domestic savings. In the case of a deficit on capital account, the credit expansion obviates the need to use domestic savings to match the capital outflow and permits the whole of domestic savings to be used for home investment.

money supply is no more than enough to finance the larger volume of production, consumption, and investment at stable prices, it is not only not inflationary, but is essential to the proper functioning of the economy. To the extent that the expansion of the money supply takes place through deficit financing and by government borrowing from the commercial banks, it makes available to the government the resources represented by such saving. To the extent that the expansion of the money supply takes place through business borrowing from the commercial banks, it makes available to the private sector the resources represented by such saving.

The Five Year Plan explicitly takes account of the use of sterling reserves and includes the use of reserves as part of the foreign resources for the plan. The Plan does not explicitly take account of the savings represented by the expansion of the money supply beyond its present level. The assumption is implicitly made that such resources will be allocated through bank loans to the private sector and that these loans will be used to finance inventory accumulations or other investment. It should be possible through credit policy to see that these resources are not directed to less productive forms of investment, but become available in larger part for productive investment within the scope of the Plan or complementary to it.

CREDIT POLICY WITH DEFICIT FINANCING

Clearly, some deficit financing is consistent with a sound credit policy designed to avoid inflation and to facilitate economic development with stability. Clearly, too, excessive deficit financing is not consistent with a sound credit policy and can lead to inflation even if it is for the purpose of undertaking development. Deficit financing is but one aspect of credit policy, and it is only on the whole range of credit policy that a judgment can be made. The practical problem for the monetary authorities is to determine how much is proper and how much is excessive deficit financing within the framework of a sound credit policy.

One magnitude of which rough estimates can be made is the aggregate amount of credit creation that may reasonably be undertaken without risking a serious inflation. The money

supply at the end of March 1953 was Rs. 18.5 billion.[2] Disregarding adventitious factors, it is probable that, if the economy develops as foreseen by the Five Year Plan, an appropriate money supply for India by March 1956 (the close of the Plan) would be close to Rs. 19.5 billion. If the drawing down of sterling balances in this three-year period should amount to Rs. 2 billion, it would be possible to reduce the cash balances of the Government of India and increase Reserve Bank and commercial bank credit by a total of close to Rs. 3 billion.

It should be pointed out that such an estimate of the total amount of credit that could be created without risking a serious inflation cannot be set up as a target in the Five Year Plan. Rather, it should be thought of as a guide to be modified to suit the actual developments in the Indian economy which are the true determinants of the amount of credit that can be created to bring about an appropriate money supply. If output in India grows more than is foreseen by the Plan, there will be a possibility of a larger expansion of credit. On the other hand, if output grows less than is foreseen by the Plan, if the actual use of sterling falls short of the agreed releases, or if the payments position deteriorates, the creation of credit cannot safely be allowed to reach this estimated figure.

Whatever the appropriate amount of credit creation may in practice prove to be, not all of it can be set aside for deficit financing. Even if credit policy could assure that such an amount of deficit financing did not give rise to an excessive expansion of the money supply, it would not be desirable to have all of the resources arising from the use of sterling reserves and savings in the form of cash balances set aside for the public sector. Some of these resources will have to be made available for credit from the banking system to private enterprise if investment is to be undertaken to increase production in agriculture and industry. Apart from this, the banking system would almost certainly expand credit excessively if deficit financing were undertaken to the full amount of the decrease in the sterling reserves and the need of the public for additional cash balances.

Suppose the Government were to draw down its cash

[2]Series reported in International Monetary Fund, *International Financial Statistics.*

balances and the Reserve Bank were to acquire Treasury securities to a total of nearly Rs. 3 billion over three years. This sum would enter into the money supply. To the extent that the deficit financing restores the money supply decreased by the use of sterling reserves, it would not increase the capacity of the banking system to expand credit. Its only effect would be to avoid a contraction of credit that might otherwise be forced on the commercial banks. To the extent that the deficit financing represents a net increase in the money supply, it would make possible a further expansion of bank credit. Part of the increase in the money supply would remain in the hands of the public as currency; but part of it would come to the banks as an increase in deposits. With increased reserves they could expand their loans, unless other action were taken to offset this. The aggregate expansion of credit, through deficit financing and the commercial banks, would be more than the economy requires for financing the increased output at stable prices. Inflationary pressures would then emerge.

It is not possible to say precisely how much deficit financing can be undertaken without risking inflation. As a minimum, it would be as much as the drawing down of sterling reserves. Beyond that, an uncertain fraction, perhaps about one half, of the net increase in the money supply could be used for deficit financing without serious risk of inflation. This proportion is high because a large part of the money supply of India consists of bank notes, so that the expansibility of bank credit on the basis of additional reserves is limited. Even if deficit financing could be safely undertaken to an amount equal to the drawing down of the sterling reserves plus some fraction of the net increase in the money supply, it would not follow that this is a desirable policy.

Deficit financing should be integrated with general credit policy. This means that deficit financing, operating within the proper money supply, must not deprive the private sector of resources for which its need may be financially no less urgent and economically no less justified than that of the Government. With uncertainty about how far the money supply can safely expand, any decision on the amount of deficit financing would have to be provisional. The Ministry of Finance should proceed cautiously, undertaking an amount of deficit financing

that would appear warranted in the light of circumstances. If the amount proves not to be excessive, borrowing from the Reserve Bank can be increased and credit policy can be slightly eased. On the other hand, if the amount proves to be excessive, borrowing from the Reserve Bank can be decreased and credit policy can be slightly tightened.

The need for effective credit policy will be greater in the future than in the recent past. The economy of India must be expected to be more dynamic with the increase in investment contemplated in the Five Year Plan; and the risks that arise from credit policy will be greater in a country in which resources are inadequate for development. The Reserve Bank of India has been successful with its flexible credit policy, and this must now be shaped to deal with new problems. It would be desirable to make the banking system even more responsive to the policies initiated by the Reserve Bank. The risks of an excessive expansion of credit would be reduced and the flexibility of credit policy would be increased if the commercial banks were to resume holding significant amounts of Treasury bills in their portfolios. The Reserve Bank is thoroughly familiar with the technical measures for encouraging such use of bank funds.

CREDIT POLICY FOR DEVELOPMENT

The carrying out of the Five Year Plan requires the mobilization of real resources available for investment. This does not mean that all investment called for by the Plan is to be regarded as having priority over all investment outside the Plan. It does mean, however, that investment that has a great effect in increasing agricultural and industrial productivity should be encouraged at the expense of investment that is profitable but has small or negligible effect in increasing productivity. Greater investment in the private sector, especially in moderate-sized industries and agriculture, may be exceedingly useful for developing production in India. Such producers have no access to the capital market and their need for additional funds can be met only through bank credit.

There are undoubtedly great difficulties in establishing a workable system of agricultural credit in India through the existing banking system. In part this arises from the absence

of banking offices in rural sectors, in part from the inability of agricultural borrowers to meet the credit requirements of banks. The Government and the Reserve Bank of India are now studying the problem of agricultural credit and a practical solution will undoubtedly be found. The difficulties regarding adequate credit for industrial purposes are of a different order. They arise almost entirely from the traditional attitudes of the banking system. Industrial enterprises can secure adequate credit facilities for short-period and seasonal needs, particularly for financing purchases of materials, processing of goods, and sale of finished products. It is only in connection with the acquisition of machinery and related facilities that adequate credit is not available to industry.

The commercial banking system of India has a conservative tradition based on the concept that deposit banks should remain exceptionally liquid and their lending operations confined primarily to short-period credit for commercial purposes. The maintenance of high banking standards is important to a sound economy; and the Reserve Bank should be encouraged in its effort to raise banking standards in India. A well-balanced portfolio of loans, including a large proportion of short maturities, is evidence of high banking standards. An excessive proportion of short-period loans for commercial purposes may merely indicate that the banking system is not providing loans to industry for the modernization and expansion of the economy.

The purpose of having short-dated, liquid loans, as distinguished from sound loans with longer maturities, is to enable banks to contract credit if this should become necessary. For an individual bank, such a contraction of credit might become necessary if it loses deposits and must meet large cash withdrawals or adverse clearings with other banks. For the banking system as a whole, a contraction of credit may be necessary if there is a balance of payments deficit involving a decline in reserves that is not matched by an expansion of Reserve Bank credit; or if there is a contraction of Reserve Bank credit to avoid a balance of payments deficit or for other reasons.

When the cash reserves of banks are as large as in India, even a moderate proportion of their loans in short-dated

maturities provides ample liquidity for all practical purposes. A higher ratio of short-dated loans can be justified on other grounds—that such loans are safer or that they are eligible for rediscount at the Reserve Bank. This is a matter of banking practice, not of credit policy. In India the preference for short-dated commercial loans is based on a tradition that emphasizes the need for liquidity by the banking system. As a consequence, the bulk of the available bank credit goes to financing the holding of goods; and very little goes to financing the expansion of production. The need for liquidity is, of course, greater for the exchange banks, which are more engaged in financing foreign trade and whose deposits may fluctuate more sharply with changes in the balance of payments of India.

Although banks give preference to commercial loans, in practice some of their lending does finance industrial expansion. This is obviously so in the case of loans for periods of two or three years or longer for acquiring equipment; and it is so in the case of short-period loans made nominally for holding inventories. Such loans enable borrowers to use more of their own resources for acquiring equipment. As the loans are often renewed at maturity, they are actually two-year or three-year loans rather than three-month or six-month loans. Such loans, when made to good borrowers, are consistent with high banking standards. They would be equally good loans if made for two or three years and specifically for the purpose of acquiring equipment.

The institutional arrangements for financing private industrial enterprise in India are not adequate. This situation is common to nearly all underdeveloped countries. The reason is that the limited industrial sector cannot provide enough savings out of business profits to finance industrial expansion even on a modest scale. At the same time, the capital markets are not designed to finance the expansion of small and moderate-sized businesses. In the United States, the commercial banks regard two-year and three-year loans for equipment as consistent with good banking practice, provided the aggregate of such loans is not excessive and the borrowers are good credit risks. This is a problem of adjusting banking standards to the needs and traditions of the country. It should by studied by the Reserve Bank of India.

The need to make more adequate provision for industrial credit has been recognized by the establishment of the Industrial Finance Corporation by the Central Government and similar institutions by some of the States. The need may not be fully met by these institutions for two reasons—they may deal primarily with larger industrial firms and their resources may not be adequate. These difficulties could be considerably alleviated if the Industrial Finance Corporation could collaborate with the banks in making industrial loans. There are many ways in which this collaboration could take place. The banks could participate with the Industrial Finance Corporation in loans to their own clients, with or without its guarantee. The banks could take the early maturities of loans and the Industrial Finance Corporation could take the later maturities. This is a matter that should be studied by the Reserve Bank of India, the Industrial Finance Corporation, and representatives of the banking system.

11

The Role of Banks in Japan's Economic Growth*

Ichiro Takeuchi

The Japanese banking system has always fascinated many in India. This paper describes the unique character of the Japanese banking system and analyses the factors behind it. The Japanese banks have played a more important part in financing private industrial investment than banks in any other part of the world. They have been enabled to do this by the practice of 'overloaning' on the basis of central bank credit. This peculiarity of Japanese banking is closely related to the financial structure of Japan and the official monetary policy. More recent changes in the economic circumstances of Japan are, however, tending to modify the role of the banking system as a channel of money supply for economic growth.

Editor

In the past decade—the 1960's—Japan's economy had been expanding rapidly by an average 11.4 per cent a year in real terms. Real economic growth rate fell below 10 per cent only twice—in 1962 and 1965—during the ten-year period. Looking ahead, Japan's economy is expected to continue to

*Ichiro Takeuchi, 'The Role of Banks in Japan's Economic Growth', in Reserve Bank of India, *Banking and Development: Report of an International Seminar*, Bombay, 1970, pp. 42-48. Reprinted by permission.

expand as fast as in the 1960's, at least in the first half of the 1970's. The high growth rate of Japan is really unparalleled in the world, and it is acknowledged generally that the major momentum behind the impressive economic growth has been a high level of investment in business plant and machinery.

Actually, the contribution of this investment activity to the economic growth had been running at the rate of nearly 20 per cent a year in the 1960's. This reflects the fact that the share of capital investment in gross national product, at 18 to 19 per cent, has been quite large by international standards and that capital investment has been rising sharply by 16.4 per cent on a yearly average.

The fast economic growth led by capital investment was the result of the following major factors: investment competition among large enterprises for expansion of their shares in the market, the highest rate of personal saving in the world, an abundant supply of superior labour, and the pursuit of fiscal and monetary policies with emphasis placed on the promotion of investment in business plant and equipment. Above all, the role played by banks as a major channel of money supply to meet the requirements of economic growth has been of outstanding significance. Here, it is notable that in financing the economic growth Japanese banks have behaved in ways singular to foreign bankers pursuing business from their commonsense standpoint. We could even say it is this peculiar behaviour of banks that has played the role of a task-master in realizing growth potentials of Japan's economy more than adequately.

I shall now give an account of Japan's experiences while focusing my attention on the behaviour peculiar to Japanese banks. Since this behaviour is closely related to the financial structure of Japan and the speciality of monetary policy I shall refer to these matters again later.

INDIRECT METHOD OF FINANCE

The banks have come to play the role of a major channel of money supply to satisfy the requirements of economic growth against the background of the development peculiar to Japan; namely, extremely heavy dependence of Japanese enterprises on

borrowing from the banks. The method by which Japanese enterprises raise funds has two salient features. One is that the rate of dependence on retained earnings and depreciation allowances is low in relation to the rate of dependence on funds from outside sources. Of late, the ratio of the former to the latter has improved to 4 to 6 from the traditional 3 to 7. Yet, things remain different from those in other major industrial nations where enterprises depend more heavily on internal sources than on external ones in raising necessary funds. The other feature is that borrowing from banks has a relatively large share in the volume of funds raised from outside sources. Such borrowing accounts for about 40 per cent of the total volume of funds raised, compared with around 5 per cent for enterprises in the United States and Britain.

The reason why business finance in Japan has taken the form of indirect finance from banks rather than the form of direct finance through the issuance of stocks and debentures is that the capital market in Japan has remained underdeveloped; so the banks have been obliged to play the role of a major channel of fund supply, whether they like it or not.[1]

The tardiness in development of the capital market in Japan, when viewed from the standpoint of enterprises, is explained by two factors: the cost of raising funds involved in the issuance of stocks is heavy relative to the cost of borrowing, mainly because of differences in tax treatment in favour of the latter, and the issuance of debentures is restrained in the context of a low interest rate policy, which will be noted later. When viewed from the standpoint of investors, the tardy development of the capital market is largely accounted for by the fact that personal savings have been generally so small that they have taken the form of bank deposits rather than investments in stocks and debentures. Had the attitude of banks toward lending been conservative, enterprises would have had no choice but to raise necessary funds through the issuance of stocks and debentures. But the fact is that the banks have been quite positive in extending loans to large enterprises in particular. This seems to have been the most important element in retarding the development of the capital market.

That the banks have been quite positive in their lending attitude is closely related to the fact that Japan's post-war

economic reconstruction proceeded through the formation of business groups with large banks as their core. If a bank was to meet competition successfully, it had to have a group of superior enterprises around it by taking advantage of its monopolistic position in business finance, thereby consolidating its business foundation at the same time. There have been cases from time to time in which they indulged in lending competition at the cost of a deterioration in their liquidity positions or without adequate study of the risk involved in lending. This led to the amount of lending and portfolio investment by a group of big banks, commonly called 'city banks' chronically exceeding deposits by a wide margin and covering fund deficiencies with borrowing from the call money market and the Bank of Japan. The liquidity position of banks is now virtually zero, and the borrowing facilities provided by the Bank of Japan represent their *de facto* liquidity reserves. Under the traditional conception of sound banking, such banking practices would be taken as very risky bank management.

'Overloaning' Practice

The truth is, it has become an expediency, now deep-seated, for big banks to extend loans to their customers in excess of deposits and depend on borrowing from the Bank of Japan to cover the excess loans. This practice is usually referred to as 'overloaning'—a distinctive characteristic of management of leading banks in Japan. Leaving aside acumen and sound practice, such bank management has proved an influential factor propelling Japan's high-rate economic growth.

The behaviour of banks that would otherwise run counter to the principle of sound banking and might cause financial disturbances, is broadly justified in the case of Japan as a major factor in the fast economic growth. This fact is worth particular attention, and cannot be evaluated apart from unique fiscal and monetary policies Japan has followed in the postwar years.

Needless to say, an economic growth necessitates an increased volume of money supply. Such additional funds needed for economic growth are usually supplied through three major channels: inflows of gold and foreign currencies; net

Government payments to the public; and credit creation by banks. During most of the 1960's Japan's gold and foreign exchange reserves had hovered low around the \$2,000-million level, and accordingly funds needed for economic growth were not supplied through the channel of gold and foreign currency inflows. Incidentally, gold and foreign currency inflows were a major channel of fund supply for the economic growth of West Germany. The situation may well change; for Japan's balance of international payments showed surpluses in 1968 and 1969, adding a substantial \$ 1,500 million to its gold and foreign exchange reserves, and the uptrend is expected to continue.

For many years after the war, Japan had maintained the principle of a balanced budget, and therefore funds needed for economic growth had not been supplied through the channel of net Government payments to the public. Receipts on General Account even exceed payments, and the resultant fund shortage was covered by bank borrowing from the Bank of Japan. The 'overloaning' practice of banks could well be justified in these circumstances. In 1965, however, long-term Government bonds were issued to cope with the recession prevailing then and subsequently they were issued every year to cover the shortage of Government funds. The Government thus departed from the principle of a balanced budget in the second half of the 1960's. Hence, there developed changes in this channel of money supply. For, the long-term Government bonds issued were digested by a syndicate of financial institutions, and after a certain period of time most of them came to be bought by the Bank of Japan. This means that the supply of funds in the form of central bank credit has been channelled through net Government payments to the public. The supply of funds needed for economic growth through this channel has grown in importance in recent years.

While the fund supply situation has thus changed somewhat, as illustrated by the issuance of long-term Government bonds and the movement of the international payments balance to surplus, bank credit creation has remained a major channel of money supply for economic growth in Japan. To be specific, the banks have actively extended loans to enterprises in response to their vigorous fund demand and made up for the resultant fund shortage through borrowing from the Bank of

Japan. The fact that there was no other channel of money supply has been the basic element justifying the behaviour of the banks that resorted to the practice of 'overloaning'.

But in all this, we have to concede that the peculiar behaviour of banks has been encouraged by the post-war fiscal and monetary policies that placed emphasis on the growth of business plant and equipment investment.

On the fiscal side, the Government has endeavoured to restrain its consumption expenditures on the principle of a balanced budget and to appropriate financial resources for business capital investment. Besides, it has facilitated business capital investment directly by virtue of the special depreciation system, a shortening of the depreciation period, preferential tax treatments, and fiscal investment and loan programmes.

On the monetary side, the monetary authorities have followed an artificial cheap money policy and placed quantitative controls on bank loans to support the policy with financial priority given to key industries, thereby facilitating business capital investment. There is no denying the fact that monetary policy with emphasis placed on the promotion of business capital investment has had a peculiar influence on the behaviour of banks.

Immediately after the War Japanese business lost most of the capital they had accumulated because of inflation and in the process of containing inflationary pressures. Hence, business had to depend on borrowing for the supply of funds needed for their capital investment. In this fund supply-demand situation, interest rates were laid open to upward pressure unless artificial steps were taken to check their upswing. Actually, however, an artificial low interest rate policy was enforced with the principal aim of strengthening the international competitiveness of Japanese businesses. In order to maintain the low interest policy, the monetary authorities imposed rigid quantitative controls on bank loans and provided funds preferentially to key industries at low interest rates.

Insofar as the banks followed this preferential loan policy, they were supplied with central bank credit with relative ease, so it is no wonder that they increased loans without regard to their liquidity positions. This was especially true when banks competed fiercely with each other. Hence, the behaviour of

banks that induced the 'overloaning' practice seems not necessarily unrelated to the fact that the banks were utilized as the medium of monetary policy used to expedite economic growth. In the circumstances in which the method of indirect finance was prevalent, the banks were in a position to fully satisfy the requirement of monetary policy.

'Stop and Go' Process

As we have seen, funds needed for economic growth have been supplied mainly through the channel of bank credit creation, which in turn expanded central bank credit. A question remains as to why there has developed no runaway inflation despite the resultant excessive 'overloaning' practice of banks. In the 1960's, consumer prices have been rising by more than 5 per cent annually and wages by more than 10 per cent a year. But, the balance of international payments showed heavy surpluses in the past two years.

This can be accounted for largely by the fact that inflationary pressures of expanding central bank credit have been contained both opportunely and appropriately. A glance at economic developments in the 1960's shows that whenever the economy became overheated because of excessive business capital investment, imports displayed a sharp upsurge, and the nation ran into a balance of payments crisis in consequence. The crisis recurred in an interval of some three years—in 1961, 1964, and 1967. Here, it should not be overlooked that behind the momentum of excessive business capital investment was an expansion of bank lending on the strength of central bank credit. In adjusting the balance of payments position, therefore, the monetary authorities placed stress on restraining central bank credit. Actually, they took rigorous restrictive measures, particularly monetary restraint.

Japan's economy has continued to grow despite the 'stop and go' process, and the monetary restraint imposed to adjust the payments position was quite effective. The adjustment process came to an end in a relatively short span of time, and subsequently the economy resumed its expansion. The fact that monetary restraint had an immediate effect can be attributed to the unique bank practice of 'overloaning'. As an instrument

of restrictive monetary policy the Bank of Japan placed direct quantitative controls on bank loans through its 'window' operations. Since the banks were heavily dependent on borrowing from the Bank of Japan, they were obliged to restrain their lending rigidly as requested by the Bank of Japan. The expansion of central bank credit was thus checked quite effectively through the 'window' operations, and the development of runaway inflation was stemmed in consequence.

Another feature of the adjustment process is that monetary restraint mainly took the form of such direct controls on bank lending and a relatively small room was left for an effective interest rate policy. As another instrument of restrictive monetary policy the Bank of Japan would increase its discount rate, but the rate of increase was always moderate. And there were no indications of the discount rate increase reducing business interest in plant and equipment investment. Hence, it is evident that an artificial low interest policy has been pursued. This was combined with stiff competition among banks to limit increases in their lending rates within the range of central bank rate increases.

Business interest in plant and equipment investment was dampened exclusively by bank restraint on lending. But this restraint was reinforced by a deterioration in bank profitability due to the Bank of Japan's 'window' operations and a sharp boost in call money rates. To be specific, the banks scrambled for call money in an effort to compensate for the fund shortage caused by the strict curb on borrowing from the Bank of Japan. This resulted in a violent upswing in call money rates. The banks were then obliged to restrain their lending from the standpoint of profitability. There is recognition that a boost in interest rates as the result of monetary restraint adversely affected bank profitability; it also reduced the availability of funds, and in turn contributed toward adjusting the balance of payments position. Yet, it can be said that the interest rate upswing played a subordinate role enhancing the effect of 'window' operations.

From the standpoint of banks, however, they were always the greatest victim of monetary restraint, finding themselves in an awkward dilemma between 'window' operations and a deterioration in profitability. It was for this reason that monetary

restraint always had immediate effect and stemmed inflation effectively.

Changes in the Role of Banks

As we have seen, Japanese banks have served to step up the economic growth through their unique *modus operandi* and played a central role in the adjustment process, thereby contributing to a steady economic growth of the nation. Worth noting here is the fact that in recent years changes have developed in the role of banks. To be specific, the emphasis in the channel of money supply for economic growth is shifting gradually from bank credit creation to net Government payments to the public or foreign currency inflows. Hence, the emphasis in the mode of granting central bank credit is shifting from loans to the banks to the purchase of bonds from the banks. Notably in 1969, foreign currency inflows emerged as a channel of money supply for economic growth, side by side with the channel of central bank credit, as the result of a substantial surplus on international payments.

These changes imply a decline in the role of banks as a source of money supply to enterprises. Partly because of rapid growth in recent years of the so-called 'near banks' like mutual loans and savings banks and credit associations, the relative importance of banks, especially big city banks, has declined in respect of both loans and deposits. Hence, the effect of monetary restraint has been reduced. This calls for a rescrutinization of monetary policy in the face of new developments such as the issuance of long-term Government bonds and the persistent payments surplus.

The banks, for their part, intend to cope with these changes through diversification of banking business, namely positive advance into the areas of consumer credit, housing loans and credit cards, or into the international financial sphere. This should be accompanied by changes in the role of banks. It would seem that the role will shift from the heretofore promotion of economic growth to the achievement of economic stability. More precisely, Japan's economic growth which has been pushed ahead through bank credit creation has reached a turning point, as evidenced by the persistent

payments surplus. Henceforth, exports will replace business capital investment as an important factor leading economic growth, and at the same time the expansion of social overhead capital, which has been left behind in the march of economic progress led by business capital investment, will pose an important problem to the nation. Then the role of banks as an element in the facilitation of economic growth will be forced to retreat, but there will remain the need for economic adjustment by virtue of monetary policy. In this situation, the banks are in a position to act as a pivot of monetary policy.

But this notwithstanding, the banks, while expanding their business foundation through diversification of banking business, will have to change their behaviour in keeping with changes in monetary policy. Indications are that monetary policy will shift its emphasis from the direct quantitative controls to indirect controls that attach importance to the adjustment function of interest rates. An indispensable prerequisite to this is to create conditions under which interest rates will function effectively in the process of economic adjustment. This necessitates the banks correcting their 'overloaned' positions and returning to the traditional behaviour that stresses the liquidity position of banks. Without such a shift in banking procedure, it would be difficult to maintain the effect of monetary policy. Moreover, retreat in the role of banks as an element expediting economic growth should be sufficiently compelling for a shift in their behaviour. Competition among banks will remain stiff, yet its emphasis is now shifting from quantity to quality.

12

The 'Real Bills' Theory of Banking*

T.M. Podolski

This essay reviews the 'real bills' theory of banking, also called the 'commercial loan' theory. The theory is supposed to be based on the principle of productive credit. It was discarded in the West mainly because, by presuming a passive adjustment of money supply to business needs, it failed to be an effective instrument of macro-economic control: such a monetary policy could not iron out economic fluctuations. The theory has been resurrected in the East European countries for an entirely new purpose, viz., the bill discounting system can be used to discipline individual business enterprises. This is of great interest in the present context of Indian banking and industry.

Editor

It has become commonplace in Western literature on Soviet-type money and banking to refer to the influence of the 'real bills' theory on Soviet monetary thought and management, particularly up to the mid-1950s.[1] Though few specific

*Taken from T. M. Podolski, *Socialist Banking and Monetary Control: the Experience of Poland*, Cambridge University Press, Cambridge, 1973, pp. 12-18. Reprinted by permission.

[1]F.D. Holzman, *Soviet Taxation*, Cambridge Mass., 1955, pp. 27 and 49. D.R. Hodgman, 'Soviet Monetary Controls through the Banking System' in G. Grossman (Ed.) *Value and Plan*, Berkeley, 1960, p. 109. Holzman's comment on Hodgman's article, ibid., pp. 127 and

details on the subject are given, one infers that Western writers disapproved of the credit system based on such theoretical premises, whether in Soviet or Western conditions. The following points emerge from their rather scanty observations on the subject: (*a*) the 'real bills' theory influenced Soviet and East European economists, (*b*) the acceptance of the theory, which has been discarded in the West, indicated a lack of sophistication in monetary thought in the East, (*c*) its acceptance resulted in liberal credit policies encouraging inflation. Because the author takes issue with the above view, because the 'real bills' theory is today rarely considered in Western economics in the form in which it is relevant to us and because it is convenient to borrow some terms from its jargon and employ them in analysing socialist credit principles, a brief account of the theory may be useful.

Monetary theories, and especially policy prescriptions based upon them, rarely make sense unless they are discussed in their historical setting and in relation to the objectives of monetary authorities and the structure and practices of the banking mechanism to which they refer. The 'real bills' theory has a long history, during which it was expounded in different economic contexts.[2]

The first concise formulation of the theory was by Adam Smith, who, it must be remembered, postulated it in the environment of small competing firms, of small-scale unit banking engaged mainly in discounting bills, in the absence of central banking as understood today, and above all in an environment of currencies convertible into gold and of expanding international

129. G. Garvy, 'The Role of the State Bank in Soviet Planning' in J. Degras (Ed.) *Soviet Planning*, Oxford, 1964, p. 48; *Money Banking and Credit in Eastern Europe*, Federal Reserve Bank of New York, 1966, p. 68. J.M. Montias, 'Bank Lending and Fiscal Policy in Eastern Europe' in G. Grossman (Ed.) *Money and Plan*, Berkeley, 1968, p. 56. In the above studies reference is often made to R.P. Powell's unpublished study on Soviet Monetary Policy (1952) which apparently criticised Soviet acceptance of the 'real bills' theory on the grounds that it allowed excessive credit expansion, rendering monetary policy ineffective against inflation.

[2]Reference to it may be found especially in L.W. Mints, *A History of Banking Theory*, Chicago, 1945; F.W. Fetter, '*Development of British Monetary Orthodoxy*, 1797-1875, Cambridge, Mass., 1965.

trade.[3] Smith made two main points: (*a*) credit against real bills, by which he meant bills drawn for values (goods) received, allowed firms to dispense with cash reserves[4] and (*b*) 'The whole paper money of every kind...never can exceed the value of the gold and silver...which...would circulate there, if there was no paper money.'[5] He argued that any excessive paper money would be returned to banks and exchanged for gold and silver, which could then possibly be sold abroad.

Smith's views on banking led to a crude formulation of the 'real bills' theory, namely that as long as banks advanced money against bills financing working capital of industry and trade, notes could not be over-issued causing inflationary pressure. In this crude form the theory was used by the Bank of England directors to justify the actions of the bank (which included an increase in note issue) during the French wars, when currency convertibility into gold was suspended.

The theory was later developed by disciples of the Banking School in the monetary controversy surrounding the Bank Charter Act of 1844. Broadly speaking the Banking School agreed with their opponents (the Currency School) that bank notes should be convertible into gold, but refused to accept the proposition that an automatic control of note issue by the inflow or outflow of gold amounted to a monetary strategy ensuring a crisis-free economic development. They refused to believe that phenomena such as inflation and falling exchange rates could be explained in purely monetary terms, suggesting that the supply of 'circulating medium' tended to adjust itself to demand and that note issue especially was governed by the 'needs of business'. In particular they developed the Smithian idea that excessive note issue automatically returned to the banking system. This was the essence of the 'law of reflux' which stated that, as long as banks were ready to convert notes into gold, over-issue and the consequent pressure on the price

[3]A. Smith, *The Wealth of Nations* (1776), London, 1965, pp. 250-94.

[4]'When a bank discounts to a merchant a real bill of exchange drawn by a real creditor upon a real debtor, and which, as soon as it becomes due, is really paid by that debtor, it only advances to him a part of the value which he would otherwise be obliged to keep by him unemployed and in ready money for answering occasional demands.' Ibid., p. 269.

[5]Ibid., p. 265.

level would not occur.[6] The 'real bills' doctrine was now formulated in broader terms, laying down that banks should lend to satisfy genuine 'needs of business' and should avoid speculative lending. In this less specific form it had a significant impact on American monetary thought.

It may be interesting to note that though the 'real bills' theory originated in Britain it is rarely considered in modern British books on banking. American books on the other hand rarely omit a reference to 'real bills' doctrine (or its synonym 'the commercial loan' theory), though few of them approve of its principles. This is not surprising, as the doctrine had some impact on the U.S. monetary policy before the Second World War. In the past the Americans tended to blame banks for business depressions and looked for a formula for an 'elastic currency' capable of rising when demand for it increased.[7] Here the 'real bills' doctrine offered a solution. The 1864 National Bank Act was to some extent inspired by the theory. More important, its tenets were accepted in the 1913 Federal Reserve Act which created the Federal Reserve System (FRS). Indeed L. Currie claimed that 'The theory of Banking underlying the Federal Reserve Act is that the primary function of banks is that of meeting the short-term borrowing needs of "legitimate" business.'[8] The culminating point in the influence of the doctrine on American credit policy came in the 1920s, when little reliance could be put on the automatic adjustment mechanism operating under the pre-war gold standard because of war disruptions and post-war tendencies towards protection in international trade.[9] FRS concentrated mainly on supplying

[6]It may be noted that Marx approved of the 'law of reflux': 'The quantity of circulating notes is regulated by the turnover requirements, and every superfluous note wends its way back immediately to the issuer.' *Capital*, Vol. 3 (1894) Moscow, 1962, p. 512. Marxian views that changes in the price level are a cause rather than the effect of changes in money supply are also consistent with the tenets of the Banking School.

[7]P. B. Trescott, *Financing American Enterprise*, New York, 1963, pp. 152-56.

[8]*The Supply and Control of Money in the United States* (1934) New York, 1968, p. 38.

[9]For a full discussion see E.R. Wicker, *Federal Reserve Monetary Policy*, 1917-1953, New York, 1966, ch. 7. For a survey of banking

credit for seasonal needs and emergencies and not on control over the supply of money as understood today. Credit creation satisfying the 'needs of business' (mainly loans against self-liquidating securities such as 'real bills') was not thought to be inflationary, whereas speculative loans and credit created on the basis of government securities were deemed inflationary. In the Tenth Annual Report (1923) the Federal Reserve Board stated that 'the FRS is a system of productive credit. It is not a system of credit for either investment or speculative purposes. Credit in the service of agriculture, industry and trade may be described comprehensively as credit for productive use.'[10] It was on the basis of this report that D.H. Robertson formulated the term 'the Principle of Productive Credit'[11] which is quoted in Holzman's book.[12] It must be mentioned that the 'real bills' doctrine lurking behind this principle became the so-called *qualitative tests* of credit issue: the Federal Reserve authorities were also to apply *quantitative tests*, where credit supply was also to be justified by 'a commensurate increase in the nation's aggregate productivity'.[13]

The 'real bills' theory was attacked almost from the very beginning of its existence. Its original Smithian formulation was rejected in a well-reasoned essay of H. Thornton who, though approving of the idea of lending against real bills as a principle of sound banking, thought that lending on good security by individual banks might not necessarily result in developments advantageous from the national point of view.[14] He feared (as indeed did Smith himself) that banks might sometimes unwittingly discount 'fictitious' bills; he was uneasy about the fact that the amount of trade bills in circulation was 'greater than the amount of all the bank notes of every kind' and about the fact that the amount of bills 'may be multiplied to an

literature on the 'real bills' doctrine in the USA after 1913 see Mints, ch. 13.

[10]*Tenth Annual Report of the Federal Reserve Board*, 1924, p. 33.

[11]'Theories of Banking Policy' (1928), *Essays in Money and Interest* Manchester, 1966, pp. 24 and 36-38.

[12]Holzman, pp. 27 and 49.

[13]*Tenth Annual Report*, p. 33.

[14]H. Thornton, *Paper Credit of Great Britain* (1802), London, 1962, esp. chs. 8-11.

extremely great extent'.[15] Thornton clearly perceived the problem, later echoed by others, that the term 'needs of business' does not signify anything specific or quantifiable from the point of view of credit expansion. In addition he thought that the issue of credit by the Bank of England should also be related to an external criterion, notably to the movement of exchange rates. Later the theory was rejected in the famous Bullion Committee report of 1810 and finally the passing of the Bank Charter Act of 1844 symbolised the preference in Britain for central banking based on rigid rules, relating the issue of notes to specie flow, rather than for a discretionary policy trying to adapt lending to legitimate 'business needs'. The revival of interest in the 'real bills' doctrine in the twenties and thirties of the twentieth century was mainly caused by the quest for an appropriate monetary policy for the FRS. The System's adherence to the 'principle of productive credit' was attacked especially by D.H. Robertson in Britain[16] and in the USA by a number of writers[17] including L. Currie.

It is important to note that both Robertson and Currie were looking for a stabilisation policy in conditions when the gold standard could no longer be relied upon to provide a guide to central banking behaviour. They were not primarily interested in sound lending or in the liquidity aspects of the distribution of bank assets, but in a national monetary policy designed to stabilise the trade cycle. Banking policies based on the 'real bills' doctrine were thought to be too passive, and hence inadequate for purposes of stabilisation. Currie, a predecessor of the present monetarist school of K. Brunner and M. Friedman, maintained that movements of commercial loans were unsuitable as indicators of a community's requirements for money, because commercial loans rose in the upswing and declined in the downswing of the trade cycle. 'Hence a strict

[15]H. Thornton, *Paper Credit of Great Britain* (1802), London, 1962, pp. 94 and 253.

[16]Robertson, pp. 36-38. See also *Banking Policy and the Price Level*, London, 1926, esp. chs. 3-6. *Money* (1922) Cambridge, 1946, ch. 5. Robertson's works are quoted in support of rejection of the 'real bills' doctrine in the West by Holzman (p. 27) though perhaps a more convincing attack was launched by L. Currie with Robertson's warm approval (see review of Currie's book in *Economic Journal*, March 1935, p. 128).

[17]See Mints, ch. 13.

application of the "needs of business" criterion would involve an expansion of money during the upswing and a contraction during the downswing of the cycle.'[18] This would accentuate the trade cycle. Thus Currie advocated the abandonment of the 'commercial loan theory' of banking and the adoption of 'monetary theory of banking', viz., monetary policy specifically designed to iron out economic fluctuations.

Indeed, as already mentioned, monetary policy in the West, especially since the early 1950s, has been anticyclical, often described as 'leaning against the wind'. Monetary stringency has been applied during periods of inflation and monetary ease during periods of recession or stagnation....

To conclude, the 'real bills' theory has been discarded[19] in the West mainly because it failed to give a specific criterion for purposes of monetary policy. Legitimate 'needs of business', even when narrowly defined in terms of 'real bills', could not be translated into a reasonably specific target variable at which monetary authorities could aim. By presuming a passive adjustment of money supply to business needs, it denied the usefulness of monetary policy as an instrument of macro-economic control and indeed was thought to encourage fluctuations. In developed Western economies the last point was crucial. Though, as stated earlier, views on the efficacy of monetary control varied, monetary policy has been a principal method of national economic management used to end inflation and alleviate balance of payments and currency crises.

The Soviet monetary management discussed in Chapter 2 clearly exhibits some elements of the 'real bills' doctrine. It may however be noted that no specific references to it are made in East European literature. It is difficult therefore to say whether the Soviet authorities took any notice of the Western

[18]Currie, p. 42.

[19]Strictly speaking the 'real bills' doctrine has been discarded in the West in the form in which it has been defined in this chapter. Elements of the doctrine still survive, though they appear in the more sophisticated setting of the contemporary debate on the question 'Does money matter?', in particular in the context of the controversy on the endogeneity or exogeneity of money supply. Those who oppose the 'new monetarism' associated with Friedman often stress the endogenous nature of money supply.

debate on the doctrine when laying down the principles of socialist banking and credit. The similarities between the doctrine and the principles may be coincidental, not necessarily implying an influence of Western economic thought. It is also doubtful whether there exists a clear 'Marxist transliteration of the real bills doctrine'.[20]

Marx's pronouncements on monetary matters[21] were, in the main, critical of capitalist theories. It is true that he leaned strongly to the Banking School view in his review of the mid-nineteenth century British monetary debate and opposed the Quantity Theory principles inherent in the Currency School. Believing that 'the quantity of means of circulation' was a dependent variable (dependent on, e.g., the price level), Marx may be classified as an adherent of the 'real bills' theory. On the other hand, from his pronouncements on money it is impossible to sift out constructive proposals which might be applicable to the monetary management of a socialist economy. It is also relevant to observe that Marx was mainly concerned with the technical functions of money in an economy on a gold standard. Strangely, although in the *Contribution to the Critique of Political Economy* he realised that 'credit money' belongs to a higher stage of production (and so presumably would apply to a socialist economy) and 'conforms to very different laws,[22] he devoted himself entirely to a discussion of the gold standard. It is doubtful whether he offered any guidance in the shaping of the Soviet monetary system.

Lenin, who exerted some practical influence in this respect, was not concerned with monetary principles, but mainly with the acquisition of the existing banking system from capitalists and its utilisation by the socialist authorities for purposes of 'control'—the accounting sort of control rather than monetary control as understood in the West.

[20] As proposed by Garvy in Degras, *Soviet Planning*, p. 48.

[21] Mainly in vols. 1 and 3 of *Capital*; also in *A Contribution to the Critique of Political Economy* (1859), London, 1971.

[22] See, e.g. pp. 64 and 116.

13

Bank Policies and Finance to Industry*

George Rosen

This essay gives a critical account of the lending policies of Indian commercial banks upto the 1950s. The author notes in particular the stress upon physical security and personal guarantee, and the confinement of bank financing generally to short-term working capital purposes. He is also critical of the control of particular banks by large individual business houses. The essay provides a useful historical perspective to the recent changes in Indian banking, particularly after nationalisation of 14 major banks in 1969.

Editor

In order to analyze the policy of banks toward the financing of industry it is first necessary to distinguish the various types of commercial banks in India and to describe their lending practices. The major distinction is between scheduled banks and nonscheduled banks. Scheduled banks have a paid-up capital and reserves of Rs. 500,000 or more, must maintain a minimum reserve with the Reserve Bank of India, and have the right to borrow from the Reserve Bank under a variety of circumstances. The nonscheduled banks are normally the

*Taken from George Rosen, *Some Aspects of Industrial Finance in India*, Bombay 1962, pp. 10-17.

smaller ones; they do not have to keep reserves with the Reserve Bank, but they can only borrow from the Reserve Bank under the emergency provisions of the current banking legislation. Both scheduled and nonscheduled banks are subject to inspection by the Reserve Bank. In 1958 there were 93 scheduled banks and 280 nonscheduled ones; the former held over 95 per cent of total bank deposits and had extended about the same proportion of all credit outstanding.

Among the scheduled banks the government-owned State Bank (formerly the privately owned Imperial Bank) was by far the largest in 1958, with more than 25 per cent of total deposits.[1] The 11 other major banks (8 Indian and 3 foreign-owned), each with deposits of at least Rs 250 million, held another 40-45 per cent, and the 81 other scheduled banks (including 13 foreign-owned) held the remaining deposits, exclusive of the approximately 3 per cent held by the nonscheduled banks. The scheduled banks' activities are largely restricted to rural or semiurban areas. The banking business of the 1,001 companies covered in the Reserve Bank's annual surveys on company finance is probably carried on entirely by the scheduled banks, and by far the largest portion by the 12 big banks (including the State Bank).

Among the scheduled banks it is useful to make a distinction between the 13 foreign-owned and the 80 Indian-owned banks. The former, which are branches of large foreign banks, carried on almost all the foreign exchange business of India prior to independence in 1947. They did not function primarily as deposit banks in India but rather as exchange banks; their major role was to supply the banking needs of foreign-owned enterprises in India and of Indian firms which carried on a large volume of foreign trade. Most were therefore located in the major Indian ports and large cities and had few if any regional branches. Since 1947, as the larger Indian banks have themselves entered the foreign exchange field and as the foreign

[1] During 1959 various separate state government banks were affiliated to the State Bank as subsidiaries but maintained their identity. If their deposits are included with those of the State Bank, this figure is 35-40 per cent. By the end of 1958 the State Bank had over 700 branches, compared with approximately 400 branches in 1951.

banks for competitive reasons have been forced to enter internal banking, this functional distinction between the two types has diminished. In 1956 the Indian-owned banks held five to six times the amount of deposits of the foreign-owned banks but had outstanding only about three to four times the amount of loans.

The usual method of lending is the overdraft, whereby the banks give their customers a limit against which they may draw. Customers are not required to use the entire limit, and they pay interest only on the portion actually drawn. These limits are normally reviewed at least once a year, renewal being almost automatic for the larger, well-connected firms. However, except when other arrangements have been made, tacitly or otherwise, the loans are usually callable on demand. Thus, while the overdraft procedure has a great deal of flexibility, the demand feature of the loans makes them basically short term in character.

The security required is customarily a pledge of goods either under the direct physical control of the bank in warehouses or, to favoured companies, under 'hypothecation', i.e., under legal lien to the bank but with the actual goods remaining in the borrower's possession. Generally the firms which receive advances on hypothecation, or unsecured advances, are the largest and most reliable ones, either because of the character of the owners or because the size and importance of the firms make it most unlikely that they would be allowed to fail. On all advances it is normal to require one or more of the leading directors to provide a personal guarantee for the amount of the advance. Keynes in 1913 listed the restrictions upon the lending policies of the large Presidency Banks (the forerunners of the Imperial Bank and later the State Bank) at that time: they could *not* lend for a period longer than six months; upon mortgage or in any other manner upon the security of immovable property; upon promissory notes bearing less than two independent names; upon personal security; or upon goods, unless the goods or the title to them were deposited with the bank as security.[2] Although the book was written in 1913, these traditions remained dominant at least until 1947 and are still

[2]J.M. Keynes, *Indian Currency and Finance*, Macmillan, London, 1913, pp. 201-202.

strong. Several generations of bankers have been brought up in this tradition. Although changes in policies are occurring, they must overcome a strong inertia.

The *Report of the Travancore-Cochin Banking Inquiry Commission* in 1956 stated the following norms for judging the performance of the many smaller banks in that state:

> ...A bank is taken as having an over-extended advances portfolio when its advances form more than 60 per cent of its deposits; we have assumed that advances against real estate exceeding 20 per cent of the total advances indicate an undesirable feature...; we have assumed that if unsecured advances including clean bills purchased and discounted exceed 30 per cent of the total advances, the position is not desirable....[3]

The strong, large banks are very particular to whom they lend since they are stronger they are in a position both to offer lower rates for deposits and to confine themselves to the safer and lower yielding advances. The previously cited Travancore-Cochin report found that the small state banks had a far greater proportion of the total unsecured advances, advances against real estate, and consumption loans against gold and silver ornaments; while the larger 'out of state' banks had a higher proportion of the more secure advances against merchandise. These 'out of state' banks also charged lower interest rates, since 'their dealings are likely to be restricted to parties of proved creditworthiness'.[4] The author was told often by Indian bankers and industrialists that the larger banks would simply be unwilling to make small advances or advances at higher rates of interest to people who might be considered marginal; the smaller up-country banks—scheduled and nonscheduled—which had to offer higher rates to attract deposits were also forced to accept, and frequently confined to, the higher interest, higher risk business.[5]

The reasons for the emphasis upon physical security and personal guarantee are understandable. The effect of the Reserve

[3]G.O.I., *Report of the Travancore-Cochin Banking Inquiry Commission*, Manager of Publications, Delhi, 1956.

[4]Ibid., pp. 32, 36.

[5]A survey of interest rates in India found that the largest banks paid the lowest interest rates on deposits, followed by the medium-size banks,

Bank's supervision is to strengthen the caution exercised by individual Indian banks. There is almost no exchange of information about customers among the banks; the customer rarely is asked for his financial history (and may consider it an insult to be asked) and in many cases has no record; collecting from a customer for default is difficult on legal grounds;[6] and there is nothing to prevent a customer from using the same security for a series of loans from different banks. Under the circumstances banks try to protect themselves to the utmost by restricting their advances to well-known people who can provide a personal guarantee and by making loans only against tangible, liquid property (merchandise being the best) which the bank normally holds itself. The emphasis on safety accounts for the difficulty encountered by persons who are new to industry or who are not well known. For these reasons, the banks do very little long-term financing, and they do very little financing of new industry that is not carried on by one of the existing large industrialists. At the same time the guarantee system almost inevitably acts to bring the larger industrialists into new enterprises and thus to further concentrate economic power.

Besides these factors the main interior criterion used by banks in determining their lending capacity is the advance-deposit ratio. A ratio of 60 per cent is considered to be safe; if the ratio rises much above this level a bank will either try to increase its deposits (by raising its interest rate on deposits) or will borrow from the Reserve Bank. In the background is the legal requirement that banks must retain a cash reserve of 5 per cent against demand deposits and 2 per cent against time deposits with the Reserve Bank. (The Reserve Bank has been given the power to raise these minima, but so far this power has not been used; normally, the banks maintain an excess over the requirements, but the extent of the excess varies seasonally.) Banks are also legally required, with some exemptions, to

and the smaller banks paid the highest rates. The variation between the lowest and highest rates paid was 0.5 to 1.0 per cent, and the difference between rates charged for advances was between 1.0 and 1.5 per cent, with the larger banks charging lower rates. • See R.B.I., *Bulletin*, Vol. 13, No. 10 (October 1959), pp. 1256–58.

[6]Without entering into banking law, apparently the bank must prove 'intent' to defraud, which is extremely difficult.

maintain a minimum ratio of 20 per cent of liquid assets, usually defined as holdings of government securities or cash, to total demand and time deposits.

Before looking at the statistical behaviour of the ratios it is worth examining in somewhat more detail the crucial nature of the advance-deposit ratio. In interviews with the author the widely held assumption was frequently repeated by Indian bankers that banks are essentially *passive* instruments in the creation of capital. They can only make loans against previously received deposits, and the deposits must be on call to meet the depositors' potential and always imminent demand for their money. This assumption has two corollary effects on bank loan policy : bank loans are for short-term trading purposes only so that they may be rapidly repaid from the proceeds of a sale, and demand deposits, since they should not be tied up, cannot be used as a basis for longer term advances against illiquid assets. When banking was largely for purposes of moving commodities or finished goods either within India or overseas the theory did no harm; it may even have been useful in discouraging banks from taking undue risks or losing close control over their loans in a period when there were few reliable businessmen and many fly-by-night ventures. In the current period of greater stability and of desired industrial growth, when there is a need for long-term finance, the theory, with its definition of banking as passive and with its two assumptions of very fluid deposits independent of loans and of loans made from previous deposits, is not only fallacious[7] but also harmful since it discourages banks from making the type of loans necessary for industrial growth.

[7]Joseph A. Schumpeter summarizes the position as follows : 'The short-term character of bank credit is indeed one of the fictions of banking theory and rests on the prejudice that banks essentially lend their depositors' money whereas their essential function lies in their creation of money, not in acting as intermediaries between borrowers and depositors. Moreover, even the most proper credit for working capital purposes is "short-term" only in a legal sense; in fact it is as long-lasting, as if it were granted once and for all, instead of being renewed continually. The real significance of legal shortness of maturity lies even here only in the possibility of the banks' continuing control and intervention at will, and in greater adaptability to clients' requirements and to the general position of the banks and of the national economy.' See 'Money and the Social Product', *International Economic Papers*, No. 6 (1956), p. 205.

The commercial banks' attitude, however, is reinforced by certain Reserve Bank policies with respect to making finance available to scheduled banks. The scheduled banks are legally able to both rediscount bills with the Reserve Bank and borrow from it; in fact, in the absence of a bill market rediscounting is unusual. The banks do borrow from the Reserve Bank against trustee securities or against demand promissory notes executed by the banks and supported by 90-day usance promissory notes of their customers. The Reserve Bank lends at the 'Bank Rate' (currently at 4 per cent), and the loans are repayable on call or after 90 days, although they are renewable. The theory that bank advances should be short-term is thus supported by the security the Reserve Bank requires for its loans and by the ostensible time-period limits on those loans, which influence the commercial banks' traditional attitude of frowning upon longer term advances.[8]

Related to this discussion is the attitude toward the role of time deposits. These began to rise relatively and absolutely after 1952 and rose very sharply during the foreign exchange crisis of 1957 and 1958, which caused a lag in domestic expenditures by business firms so that they had idle resources to invest in time deposits at 3-4 per cent interest. At the same time U.S. counterpart funds held with the State Bank as time deposits also rose sharply. By the end of 1958, time deposits of scheduled banks totalled Rs. 8,800 million against only Rs. 6,950 million of current deposits. The increase in time deposits has been used as an argument for the banks to expand their volume of long-term financing. They are considered to be real savings, against which the banks can safely expand longer term advances, in contrast to the more ephemeral and volatile current deposits. In interviews with the author, however, it was claimed by bankers that the distinction is really artificial, since the growth in time deposits after 1957, apart from those arising from U.S. counterpart funds, reflects the shortage of foreign exchange; that these time deposits are largely for less than six months' duration and in fact are withdrawable on call although they

[8]The role of the Refinance Corporation, which was set up to stimulate the banks to make longer term loans to industry, is discussed elsewhere. So far its effects have been minor and disappointing.

earn interest: that for these reasons they do not provide a better basis for long-term credit than the current deposits. The points expressed by the bankers have validity within the argument's context; but if the previous analysis, which discards the key role of the advance-deposit relationship is correct, the entire argument with respect to time deposits has little relevance to the ability of banks to make longer term loans. However, if the rise in time deposits does lead to a large volume of longer term financing, the argument would be of value pragmatically even though it would be largely irrelevant theoretically.

One other aspect of contemporary Indian banking should be mentioned—the close relationship between various large individual entrepreneurs and individual banks which they may either have started, or control, or on whose boards they are represented. Although there is little or no evidence that the banks are misusing their control of funds to help the owners or directors, and even no evidence that larger firms of a particular ownership group bank exclusively with the bank affiliated with that group,[9] it is reasonable to suppose that the firms of the group would be able, if the need arose, to obtain finance from the bank affiliated with it. The finance may not only take the form of traditional short-term credit but also of longer term credit, in some cases directly, in others by renewal or extension of short-term loans, and in still others by purchase of securities or loans against the securities of the companies within the group. This is desirable if it does lead to increasing output of desired types. However, it also contributes to a further concentration of control in the economic life of India; and it further strengthens the tendencies existing in India which put new and smaller industrialists at a disadvantage relative to the large existing ones in their access to capital markets.

Thus when we examine the policies of Indian banks we find a stress upon physical security and personal guarantee, reasonable within the context of banking problems in India, and

[9]This proves little since the larger firms are of sufficiently good credit standing to be able to get short-term credit from any bank. There is no way at present of examining the finance of the newer or smaller firms of a group, and their relation to the group's bank, without a very thorough and time-consuming analysis of innumerable balance sheets of the group's firms.

a stress upon short-term trading loans arising in part from the past economic history of, and forms of business organization in India, and in part from a borrowed tradition of English banking which has been hardened into an obsolete theory of banking that is neither accurate nor useful. The result has been that, while the traditional policies of Indian banks contribute quite successfully to meeting the short-term needs of existing Indian industries and merchants, their contribution to the longer term needs of industry and to the requirements of the potential new industrialists has been either indirect or peripheral.

14

Organizational Framework for Implementation of Social Objectives*

This is a summarised version of the Report of a Study Group appointed in October 1968 by the National Credit Council which was set up by the Government of India in early 1968. The Study Group examined the structure of the Indian banking system from the wide angle of social objectives. The Group's report pinpoints the deficiencies of the banking system and indicates the directions of future advance. The Group's recommendations have provided the basis of the recent official policy towards banking expansion in India. The idea of the 'lead bank scheme' originated with this Study Group. The Group pointed to the desirability of re-orienting the structure of the banking system to increase availability of credit to sectors hitherto neglected viz., agriculture, small borrowers and weaker sections of the community, and exports. It also emphasized the need for shifting the emphasis in lending policies and procedures from tangible security to viability of operation and worthiness of purpose.

The Study Group comprised Prof. D.R. Gadgil as Chairman and Shri N.M. Choksi,

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Shri P.N. Damry, Shri B.K. Dutt, Shri M.Y. Ghorpade, Shri Arvind N. Mafatlal, Shri P. Natesan and Shri T.A. Pai as Members, and Shri B.N. Adarkar, Deputy Governor of the Reserve Bank of India, as the Convener.

Editor

STRUCTURE OF THE BANKING SYSTEM

The credit needs of the Indian economy are met by both the organised and the unorganised credit agencies. The organised sector consists of the Reserve Bank of India, commercial and co-operative banks and specialised financial institutions. The unorganised market is largely made up of indigenous bankers and money-lenders.

The commercial banking system is largely of the branch banking type. Over the last two decades, the number of small banks has been reduced with the result that the total number of banks fell from 566 in 1951 to 89 in June 1969, but over the same period, the number of offices of commercial banks increased from 4,151 to 8,254. Of the 89 commercial banks, 73 are scheduled and 16 are nonscheduled banks. Of the former, 15 are banks incorporated outside India. With the nationalisation of the 14 major Indian scheduled commercial banks on July 19, 1969, the proportion of banking business in the hands of the various categories of banks is as under:

(*a*) **State Sector**	... ...	...**83 per cent**
State Bank of India, its subsidiaries (7) and the fourteen nationalised major Indian scheduled commercial banks.		
(*b*) **Private Sector**	... ...	. .**17 per cent**
of which :		
(*i*) Indian scheduled commercial banks (36)		... 6 per cent
(*ii*) Banks incorporated outside India (15)		...10 per cent
(*iii*) Non-scheduled commercial banks (16)		... 1 per cent

In recent years, commercial banks have opened increasingly large number of offices, particularly in places with population below 10,000. Even so, as of April 1969, there were 617 towns out of 2,700 in the country which were not covered by commercial banks. Out of 617 unbanked towns, 444 did not have co-operative banking facilities either. Out of about 6 lakh villages in the country, only about 5,000 are estimated to be served by commercial banks in one way or the other. Although the average population served by a commercial bank office has declined from 98,000 in 1956 to 78,000 in 1967, it is still high compared to advanced countries, for instance, 4,000 in the U.K. and 7,000 in the U.S.A. Commercial bank deposits, as proportion of national income, formed hardlv 14 per cent in India as compared to 84 per cent in Japan, 56 per cent in the U.S.A. and 49 per cent in Canada.

There is an uneven spread of bank offices and banking business as between different States and population groups. There is a pronounced urban-orientation. Even within developed States. bank credit is concentrated in the major cities. For instance, two cities—Bombay and Calcutta—alone account for 32 per cent of deposits and 51 per cent of bank credit. Excluding Bombay and Calcutta from Maharashtra and West Bengal, respectively, the share of these States in total bank credit shows a steep decline from 32 per cent to 3 per cent for Maharashtra and from 23 per cent to less than 1 per cent for West Bengal.

There is also a flow of resources from the smaller to the larger population centres and from the rural to the urban centres. The credit-deposit ratio was as high as 89 per cent in centres with population above 10 lakhs and showed a declining trend in lower population groups with only 41 per cent for centres in the population group of less than 10,000. In this connection it has to be remembered that a portion of credit given in one place may in fact be utilised elsewhere. For a meaningful understanding of the regional distribution of credit, it is necessary to collect the requisite data. The Group suggests that the Reserve Bank should take appropriate steps in this regard.

The per capita bank credit for the country as a whole was Rs. 54 and per capita deposits Rs. 78. The per capita deposits

are nearly 17 per cent of the per capita income in the country. There are wide disparities in per capita deposits and per capita credit as between different regions. There were as many as 63 districts in which per capita credit was less than Re. 1. The national average for credit-deposit ratio was 69 per cent. In 23 districts, it was more than 100 per cent and in 31 districts, less than 5 per cent. Out of 336 districts in the Indian Union, commercial bank offices did not exist in 13 districts upto the end of 1967. The average population served by a bank office ranged between 1 lakh and 2 lakhs in as many as 89 districts; it was above 2 lakhs in 88 districts.

Over the last few years, the number of borrowing accounts of the commercial banks has declined by 22,000 from 10.8 lakhs in April 1961 to 10.6 lakhs in March 1967. Although the decline can be explained in terms of factors like reduction in the number of small banks, the fact remains that banks have not succeeded in making credit facilities available to a wider section of the population despite an increase in their resources and an increase in the quantum of credit extended by them; moreover, the decline in the number of accounts happened at a time when the needs of the economy demanded a wider dispersal of credit.

The co-operative credit structure for short and medium-term credit is a three tier system, with a state co-operative bank at the apex level in each state, the central co-operative bank at the district level and the primary credit societies at the base—agricultural credit societies in villages and urban banks and other non-agricultural credit societies mainly in towns and cities. For long-term credit, there is a central land development bank in each state operating through branches in some states or through primary land development bank at taluka or district level. There are in addition a few industrial co-operative banks operating at the state or district level.

In contrast to the commercial banking system which is mainly urban-oriented, co-operative banking has penetrated into rural areas. The centres at which co-operatives provide credit facilities are not only numerous but well dispersed. The number of villages covered by active primary agricultural credit societies at the end of June 1967 was 82 per cent of all the villages in the country. The membership of these societies was

24 million. It has been estimated that 30 per cent of the total number of rural families were covered by membership of active societies. However, the percentage of borrowing members to total number of members was only 40.

The classification of loans issued by primary agricultural credit societies according to the size of loan advanced shows that small loans upto Rs. 100 formed only 9 per cent of the total amount. while loans exceeding Rs. 500 formed 46 per cent.

As in the case of commercial banks, the effective coverage of the co-operatives is highly uneven as between different states. The overall progress of the co-operative movement is more satisfactory in Gujarat, Maharashtra. Punjab and Mysore and very slow in Assam, Bihar, Orissa, Rajasthan and Jammu and Kashmir.

The main shortcomings of the co-operative system which vary from state to state are the problems of overdues, indifferent managements, dominance of co-operatives by vested interests, shortage of resources. lack of efforts to mobilise deposits untrained staff and weak arrangement for linking credit with marketing.

Land development banks which meet the long-term credit needs of the agricultural sector have attained significant levels of operations during the last few years particularly since the commencement of the Third Five-Year Plan. Individual membership (excluding nominal members of these banks) was 4.66.176 and that of the primary banks 12.54.590, but there is a wide disparity in the progress of these banks as between different States. They are generally weak in Rajasthan and eastern States of Assam. Bihar and Orissa.

Non-agricultural credit societies comprise mainly employees' credit societies and urban co-operative banks. The total number of employees' credit societies at the end of June 1967 was 9.704 with a total membership of about 45 lakhs. On the basis of certain assumptions. it is estimated that 28 per cent of the number of employed persons are members of these societies. These societies are. however, unevenly distributed as between different States. Four States (Maharashtra, Gujarat, West Bengal and Tamil Nadu) have 52 per cent of the total number of active societies and are responsible for 69 per cent of the total membership of all societies.

Urban co-operative banks ordinarily finance small-scale units which are not organised into co-operative societies. The main difficulties faced by these banks are paucity of their overall resources and the restrictive provisions in the bye-laws regarding membership and ceiling on interest rates on loans, etc. The coverage of urban banks is also uneven and three-fourths of these banks coming under the purview of the Banking Regulation Act are concentrated in four States, namely, Maharashtra, Gujarat, Mysore and Tamil Nadu.

There are also industrial co-operative banks which exist at the state and district level. Most of these banks have come into existence after 1963-64 and have not been able to assist industrial co-operative societies to any large extent. The owned funds of a number of these banks are meagre and this comes in the way of their borrowing adequately from higher financing agencies.

It is interesting to observe that the areas where banking—both commercial and co-operative—has recorded progress are common, except West Bengal. Even in West Bengal, excluding Calcutta, both commercial and co-operative banks have made little headway. The factors behind imbalances in the development of commercial banks and co-operatives in different states were studied in detail with reference to four States, Maharashtra and Gujarat, on the one hand, representing the developed States and Bihar and Orissa, on the other, representing underdeveloped States. The analysis brought out the close correlation between the level of economic activity and the growth of banking facilities. It also showed how institutional and extra-institutional factors favoured or retarded banking facilities.

CREDIT GAPS

In addition to the uneven distribution of credit as between different States, there is also uneven distribution of credit to different economic sectors and virtual non-availability to certain types of borrowers, particularly small borrowers and weaker sections of the community. The Group made a rough assessment of the credit requirements of the major sectors of the economy, agriculture, industry and trading companies and the extent to which they are met by institutional agencies. It was estimated that about 39 per cent of the total credit requirements

of agriculture were met by institutional credit agencies in 1967-68. Even allowing for the fact that all the small-scale industrial units could not immediately be brought under the purview of the banking system, the estimates showed that the gap between the credit requirements of a portion of small-scale units and the credit made available to this sector by institutional agencies was at least 35 per cent.

The sectoral distribution of credit by commercial banks is weighted in favour of large-scale industries, wholesale trade and commerce rather than agriculture, small-scale industry, retail trade and small borrowers. Agriculture excluding plantations accounted for less than 1 per cent of total bank credit and advances to retail trade accounted for less than 2 per cent.

Apart from the uneven distribution of credit to the major sectors of the economy, the statistical data and case studies undertaken for the Group showed that credit extended by commercial banks was not widely dispersed and there were credit gaps particularly in the case of small borrowers. In the case of scheduled commercial banks for instance, 81 per cent of the total borrowing accounts are currently for amounts upto Rs. 10,000, but they account for less than 4 per cent of total bank credit. On the other hand, only 437 accounts out of more than a million, claim as much as 23 per cent of total bank credit. It appears that the small banks cater to the needs of the small borrowers to a larger extent than the bigger banks do.

On examining the small loans it was found that gold loans —which played an important part so far as credit to small borrowers is concerned—have shown a steady decline during the last few years mainly on account of the imposition of Gold Control. The Group recommended that banks should be exempted from declaring their gold which they hold as security in respect of each advance not exceeding Rs. 1,000. This would enable them to make small loans and reduce their administrative burden.

The case studies undertaken for the Group confirmed that there was potential demand for credit by small borrowers, but the non-existence of institutional facilities resulted in their approaching the moneylender. It was brought to the notice of the Group, for instance, that small hawkers borrowed money from the moneylender on a day-to-day basis at fantastic rates of

interest—Rs. 20 borrowed in the morning were repaid in the evening with an interest of Rs. 2. This on a simple calculation, means a rate of interest of more than 3,600 per cent per annum! The Surveys of Small-scale Industries in Sangli, Varanasi, Rajkot and Ranchi conducted by the State Bank of India clearly showed that a number of these industries were in need of credit and that the availability of credit from the commercial banks would lead to a reduction in the cost of their production because of better utilisation of capacity. The case studies undertaken by the Reserve Bank of India established that even in places where major banks were operating and the scope for extending credit to cultivators or small artisans was fairly large, institutional credit was not extended. In Tanda (Uttar Pradesh), for instance, which is one of the biggest handloom cloth centres in the State, though three bank offices are working, the weavers are not getting the benefit of adequate institutional finance at reasonable rates of interest. It is reported that the handloom industry is presently being financed by **Mahajans** who charge interest at the rate of 35 per cent per annum.

The non-availability of institutional credit resulted in the small artisans approaching the trader who is his rival in business or the money-lender (Aligarh Lock Makers). The Survey of Credit Needs of Tanners and Leather Workers in Dharavi showed that the purchase of raw materials on credit, though free of interest, led to a great deal of exploitation of leather workers by traders, as they had to accept the material even if it was of sub-standard quality and sell the finished goods to the creditor/trader only at a pre-settled price which was lower than that warranted by market conditions, the discount being large enough to cover interest at the rate at which moneylender advanced loans, i.e., 24 to 36 per cent per annum.

One of the important reasons for lack of extension of credit by institutional agencies to the small artisan was the lack of his ability to provide collateral to the satisfaction of the bank. The vicious circle created by low income leading to low or no surplus of income over expenditure resulted in low repayment capacity of the small artisan and hence the reluctance of banks and other institutional agencies to make advances. If the vicious circle is broken at some point, by making advances of small amounts to the small artisan, improvement in his repaying

capacity would be out of proportion to the amount of loan so made (Aligarh Lock Makers). Certain established practices of banks regarding the eligibility of security complicate the sanction of loans. For example, none of the raw materials used by the printing industry in Madras is acceptable to the banks as security. This complicates matters, particularly when the machines are already pledged for medium-term loans. Several of the printers interviewed in the course of conducting case studies felt that it was unreasonable on the part of the banks not to accept 'types' as security, if not at the value of the types, at least at their metal value. Another factor responsible for a negligible flow of credit from the organised lending agencies to small artisans, is the lack of contact between the small artisan and the institutional agencies. Many of the artisans are uneducated and ignorant of the facilities which can be available to them. Two case studies 'Aligarh Lock Makers' and 'The Printing Industry in Madras', showed that wherever there were contacts between the small artisans and the banks, procedural difficulties were easily overcome.

Some of the borrowers covered by case studies were quite ambitious, had the necessary technical skill and were prepared to approach the banks, but the paper work involved and the time-consuming nature of the sanctioning of loans prevented them from making applications. Some of them were suspicious of the officials who assessed the value of their assets in case an application was made to one of the official agencies. In one case, credit was granted by a commercial bank for six months only and the repayment of loan was to begin in the first month itself, although the minimum period of turnover was three months (Aligarh Lock Makers).

In many cases, it was found that banking hours did not suit small borrowers. In the case of Aligarh Lock Makers, for instance, the Railway Receipts and Truck Receipts were usually ready only by the afternoon when the trader would need money to pay the artisan, but by that time, the banks would have closed for business. Therefore, advances were taken against RRs and TRs from indigenous bankers.

Another important reason for the reluctance of banks to extend credit to small artisans is that banks do not have any motivation to approach small artisans because the time and effort

involved in this business is out of proportion to the expected returns. It appeared from case studies that branches of some of the major banks considered the small artisans as outside their field of operations because they thought that the State Bank of India would take care of such borrowers. Moreover, in many cases, they did not have the necessary technical personnel for processing the loan applications from the small artisans and appraising the proposals (Aligarh Lock Makers).

So far as the rural artisans are concerned, they are expected to receive credit from the village credit societies but experience in this regard has not been encouraging.

The case studies relating to urban co-operative banks showed that some of these banks assisted the small-scale industries. Some of them cater mainly to the needs of particular types of members based on community, caste, profession, etc.; the lending policies of these banks are security and surety-oriented. These banks are also faced with resources-constraint. The Study Group has recommended that the Credit Guarantee Organisation should consider the non-licensed banks (under which category urban co-operative banks will also fall) to be eligible for purposes of credit guarantee under the Scheme.

Fishermen represent another sector of small borrowers who do not get sufficient institutional credit. A case study of the procedure of sanctioning loans in Maharashtra revealed that fishermen are not directly given any loans by the Government and that all loans to them are routed through co-operatives. Members of the co-operatives feel that the prices of their produce through co-operatives are not attractive as compared to those paid by merchants. Hence, a large section of fishermen does not join the co-operatives and thus remains debarred from Government assistance. Another interesting feature is that at present non-fishermen entrepreneurs who desire to undertake fishing as business as also fishermen who are not willing to join co-operative societies, are not eligible for any loan from the Government or co-operative agencies. They have, therefore, to depend on finance from private agencies. The case study relating to the State Bank of India and Fishing Industry showed that the general tendency at present is that non-fishermen entrepreneurs avail themselves of the facility of loan from commercial banks and employ fishermen as wage-earners. A special problem

which hinders institutionalisation of credit facilities to small fishermen is a rigid and time-honoured organisation which comes in the way of making banks interested in these borrowers. The fishermen of Tuticorin are mostly wage-earners who are indebted to their employers (boat-owners) both for production and consumption loans. These loans bind fishermen to the service of the lender. The boat-owners (Sammatiyars), in their turn, are indebted to the financiers (Vattakarars) for their credit requirements. Thus, the Sammatiyars are bound to serve the Vattakarars even as the fishermen are bound to serve the Sammatiyars. This peculiar organisation results in a low price for the catch being available to fishermen. There is thus a barrier between the fishing industry as at present organised and the commercial banks.

The credit problems of small farmers require special emphasis and call for urgent solution because apart from the fact that large numbers are involved, there is apprehension that the new agricultural strategy may aggravate the economic disparity which already exists between different parts of the country and different sections of the cultivators. It appeared from case studies undertaken for the Group that even co-operatives do not meet the credit needs of small farmers. In fact, there were instances of discrimination as between tenants and land-owners. In one case, the tenant obtained credit at Rs. 150 per acre and the land-owner at Rs. 250 per acre (Field Study of the Small Farmers in Mehsana District of Gujarat State). The problem, therefore, is one of meeting the credit requirements of disadvantaged cultivators of various categories—those whose holdings are small, those who carry on their farming under difficult conditions (area of frequent crop failures) and those whose tenurial status is unsatisfactory or uncertain (share croppers and oral lessees). The Group suggests that the criterion of viability of a small farmer should not be judged merely by the land he owns or cultivates, but by his character and his progressiveness as indicated by his responsiveness to scientific inputs in agriculture. The Group also suggests that group loans should be encouraged for the small farmers. Since the main problem in extending the loans to the small farmer is the lack of adequate security that he can offer, the Group suggests that individual banks should evolve their own schemes

to help the small farmer, depending upon the circumstances prevailing in the particular areas where they would be operating. The success of these schemes would depend on the adequacy of organization and appropriate staff attitudes.

A Study of the Credit Problems of Adivasis showed that an imaginative scheme for providing both production and consumption finance even in a backward region for a backward class can succeed in reducing the dependence of borrowers on the moneylender, although the chances of the success of such schemes would be greater if overhead facilities, e.g., roads and agricultural extension service are made available.

Retail trade offers another sector where commercial bank credit is negligible, although the growing rural incomes and the consequent increase in demand for consumer goods are expected to result in creating a potential for commercial bank credit for this sector also. The extension of bank credit to retail trade will depend on the improvement in the structure of retail trade and the removal of certain practical problems faced by commercial banks.

There is also a credit gap so far as consumption needs are concerned. Available data established that smaller banks gave a relatively larger proportion of their total credit as consumer loans and, more importantly, they catered to the consumption credit requirements of the very small borrowers. This probably is due to the fact that structurally they are more suited to have a large number of small accounts, since such loans involve a personalised service. More recently, some of the bigger banks have started giving loans for purchase of durable consumer goods but loans for social purposes like treatment of illness, education, etc., are still rather uncommon. The major difficulties which the large banks face in granting consumer loans are the cost and effort involved in managing a large number of small loans and following them up. The banks also seem to be of the view that the ceiling on interest rate, as prescribed at present, does not give them sufficient incentive to enter into this business. The Group feels that the levy of a once-and-for-all service charge is justified. To a limited extent, consumer credit needs are also met by the Employees' Co-operative Credit Societies. The operations of these societies are confined to those in regular salaried

employment and their coverage is, therefore, limited and unevenly spread.

The Group also undertook three case studies to see how far the credit system of the country was suited to meet certain emergency needs, for example, earthquakes, floods, etc. Our case studies showed that resources were not generally a constraint for providing facilities for the rehabilitation of victims of natural disasters. The main problem was that of evolving proper and prompt organizational arrangements. The Group is of the view that in case banks face some difficulties on such occasions, concessional refinance should be made available by the Reserve Bank of India and that on such occasions, the Reserve Bank of India should take the lead and co-ordinate rehabilitation efforts of financial agencies.

GROUP'S APPROACH TO THE PROBLEMS OF CREDIT GAPS

The analysis of the existing structure of the banking system and the nature of credit gaps shows the strength and the weakness of commercial and co-operative banks. The major nationalised commercial banks have very large resources and trained staff at their command, but their organization and the pattern of their business and procedures are not attuned to dealing with small borrowers. The staff requirements in the past have also been related to the pattern of the business that has evolved over recent decades and the bulk of their staff is not oriented to rural living nor to small-scale operations which require a great deal of examination of detail and exercise of discrimination. Non-nationalised banks, many of which are local banks, are organizationally suited to handle small business and establish local contacts but they are confined to a limited area and their resources are extremely limited. The co-operative banking system is an integrated one and, because of its three-tier structure, has been enabled to extend credit to agriculturists, artisans and small men in general. The three-tier system also allows a rationalised flow of resources from the metropolitan centres to the villages and combines this with fairly low costs of operations. On the other hand the co-operative system suffers from a number of drawbacks and there are extremely

large variations in the quality of performance and effectiveness of co-operatives. It would, therefore, be difficult to implement an all-India policy through the co-operative system alone. Moreover, the District and State co-operative banks ordinarily finance only societies and not individuals, which creates a difficulty in using these central financing agencies as a channel for supplying credit to individual borrowers where other institutional facilities are not available.

It appears necessary to make detailed plans for the development of credit and banking in the country on the basis of local conditions. The first recommendation of the Group, therefore, is for the adoption of an area approach to evolve plans and programmes for the development of banking and credit structure. The area approach is inherent in the co-operative system. So far as commercial banks are concerned the central idea is that depending upon the area of operations and the location, commercial banks should be assigned particular districts in an area where they should act as pace-setters providing integrated banking facilities and in this way, all the districts in the country should be covered.

The district should be the lowest unit under an area approach because it is the unit in relation to which the co-operative structure is at present organised and most statistical and other data are available at the district level. Moreover, the number of districts in the country is not too large to think in terms of an effort being made for evolving plans for each district.

In formulating and implementing plans of development of credit and banking in each district, it is necessary to bring together all concerned elements. However, the leading part in formulating and implementing the plan will have to be taken by the commercial banks, central co-operative banks and the co-operative land development banks. In each district, one or two nationalised commercial banks, in addition to the State Bank of India, should take a leading part in banking development.

Each district plan to be formulated will have three aspects: (*i*) that of establishment of branches or new units at particular places, (*ii*) that of formulating relationships within a structure or as between structures, and (*iii*) the formulation of proper policies and procedures. Apart from the opening of new branches by the named nationalised or non-nationalised banks

and by the district central co-operative land development banks, the plan will have to give attention to the establishment of new banking or co-operative society units. In the commercial banking structure, these new units can be a small local bank or a district bank. In view of the initial weakness of new units, it is expected that they could come into existence chiefly through support from the bigger banks in the form of financial, managerial and technical assistance. It is the experience in every branch of economic activity that meeting the needs of the small man is a dispersed, highly localised and small-scale operation which can best be carried out by local institutions which operate on the basis of personal knowledge of local conditions. The Group, therefore, supported the present policy of the Reserve Bank of India which allows the small banks to develop and does not insist on merger on account of the small size of a bank. In the co-operative sector, the establishment of new urban co-operative banks and a new type of rural primary bank should be deliberately encouraged. There is also a case for establishing a new type of rural primary bank or converting existing multipurpose credit societies into banks. Apart from primary co-operative societies, the plan should include a programme for formulation of marketing and processing societies which may be allowed as a transitional measure to extend production credit where the primary societies are not strong.

The second aspect of a district plan is the operational one of formulating dynamic interrelationships. It is assumed that the position of the State Bank of India in a district plan will not be essentially different from that of the other nationalised commercial banks. Within the commercial banking structure, an appropriate relationship will be developed between the nationalised banks and the non-nationalised banks so as to utilise the services of both in meeting the credit needs in various districts, the nationalised banks providing the leadership in this matter. This relationship can be of a variety of types depending on what policies it is decided the particular nationalised banks should pursue and the nature of the old or the newly established non-nationalised units. One possible area of co-operantion is through the bigger banks making participation arrangements with local banks or co-operatives operating in such areas.

The problem of relationship as between the co-operatives

and the commercial banking structure should be decided on the basis of the general principle that the relations within the co-operative structure would be maintained on the normal lines wherever the appropriate units in the structure have enough strength; where this is not the case, the functions to be performed by the non-existent or weak co-operative institutions would be performed by corresponding commercial banking units. Specific consent of the co-operative banking unit whose place is being filled by a commercial bank will normally be obtained. However, in particular cases where it is felt that consent is being withheld with valid reasons, the nationalised banks could act in consultation with the Reserve Bank of India and after obtaining permission of the Registrar of the Co-operative Societies of the State. In defining this relationship between commercial and co-operative banks, it has to be borne in mind that commercial banks have to continue to discharge the responsibilities and do the business which they carry out at present. The Group explored the areas of co-ordination between the commercial banks and the co-operatives. First, since financing of a borrower both by the co-operatives and the commercial banks might result in over-financing and the consequent default in repayment, it is important to ensure that one lending agency meets all the credit requirements of a borrower. Secondly, since co-operative banks and societies are often unable to utilise the available resources because of their administrative failures, commercial banks should assist them in such situations by providing managerial assistance and other facilities. Thirdly, in places where it is deemed necessary, a district co-operative bank should be allowed to deal with individuals as an interim measure till such time as a commercial bank or a strong primary society is established. Fourthly, while the Group was generally disinclined to the suggestion that commercial banks should place deposits with co-operatives in order to assist them, it was of the view that they can enlarge their support to co-operative institutions by giving them loans. They can increase their assistance to processing and marketing societies where the latter are unable to obtain financial assistance from their own sources, and subscribe more to land development bank debentures. There should also be no objection to commercial banks directly financing primary agricultural credit societies. There are many

central co-operative banks in the country which are incapable of providing adequate credit facilities to affiliated credit societies as they have failed to develop the necessary financial and administrative competence to take full advantage of even the limited credit facilities from the Reserve Bank of India. There are thus large credit gaps to be filled in the sphere of agricultural production credit. At the same time, the capacity of a branch of a commercial or co-operative bank to deal directly with several hundred individual agriculturists residing within its jurisdiction is extremely limited. Moreover, for financing agriculturists directly, commercial banks have to face several problems, for example, there are restrictions on the transferability of land, heavy stamp duties for registration of mortgage deeds, etc. Thus, a direct relationship between a commercial bank and a primary co-operative society will solve a number of problems.

Apart from defining the inter-relationships between the commercial and co-operative banking and credit structures, the credit plan for a district should pay attention to integration of credit and banking business with other activities. Within the credit structure itself, the long and short term institutions should be brought together more meaningfully. This will make it possible to link together the provision for long-term capital and working capital. Moreover, other aspects such as sale and supply, equipment and technique, product mix and marketing must also be fully looked after. This can be done on a regular institutional basis only when the institutions whether in the private or in the nationalised sector or in the co-operative sector looking after supply of equipment and technical assistance, raw material allocation and marketing, work together with the relevant short- and long-term credit institutions and are fully kept informed of each other's activities and experience. It is necessary to emphasise that the rehabilitation of the economy of the artisans or any such class is possible only if they are freed from dependence on middle-men for supply of materials or marketing of the produce. It is from this point of view that the establishment of new institutions in the credit plan has necessarily to make provisions for new societies of the combined supply, credit and marketing type.

The third aspect of the district plan is related to refashioning the present policies and procedures of the banking and credit

institutions. There must be a shift on the part of all credit institutions in the emphasis from tangible security to operational viability. Such shift is possible only when the credit institution is able to maintain a continuous contact with the borrower's operations. In this context, it is necessary that commercial banks streamline their internal organization in order to discharge their new responsibilities adequately. A centralised machinery and a measure of centralised action in regard to the task of carrying out field studies, training the staff, etc., will not only mean economy of effort, but also better co-ordination. The Agricultural Finance Corporation Ltd., which presents one such co-operative effort on the part of the commercial banks has proved very useful in processing the loan applications for agricultural projects. It will also be useful for the commercial banks to have improved arrangements for exchange of credit information.

The Group was of the view that an element of subsidy should not be mixed up with banking business. Apart from such promotional expenditure as a credit institution can and should undertake, the subsidisation, thought desirable, because of national policy in favour of any category, should come from the State or any other proper authority giving the subsidy either directly or through the banking system, by making it possible for the banks to lower their normal charges.

As a matter of general policy, a close examination may be conducted of the present working of credit guarantee schemes and a view may be taken of the extent to which these can be liberalised or applied to new fields so as to provide further assistance to banks and credit institutions in extending credit to small business and weaker sections. As a general rule, it may be postulated that the greater the financial strength of a bank, the more the burden it should assume of promotional and other expenditure. It is extremely important to emphasise programmes for the encouragement of thrift and savings and for active mobilisation of additional resources in future policy and operations. Also it is necessary to correlate savings with lending operations in some measure. In view of the importance of basic attitudes and approaches in this connection, considerable reliance would continue to be placed on incentives to and effort of the bank management and staff of individual

banking organizations—commercial and co-operative.

The two main pre-conditions required for making finance available on a larger scale and universally to weaker sections are: (*i*) integrating the lending business with sale, production and marketing activities, and (*ii*) making it possible for everybody to build up some kind of minimum financial asset in the shape of provident fund, insurance, bonus expectation or savings-deposit scheme on which the initial advance could be based.

In the light of the various suggestions given by the Group, the immediate action that is required is to create an apparatus to evolve an action programme for the next one or two years in respect of a district or a zone consisting of one or more districts. For this purpose District or Zonal Committees should be formed within the next one month or so, preferably at the initiative of the State Governments concerned, and consisting, among others, of representatives of nationalised commercial banks and co-operative banks. concerned State Government departments such as agriculture, co-operation and small industries. The Committee should have appropriate liaison with marketing, processing and other non-financial agencies of the Central and State Governments operating in the area. These Committees should be in a position to evolve a programme of action on the basis of data immediately available without waiting for any further data, and could generally function on the basis of general guidelines given by the Reserve Bank of India.

Simultaneously with immediate action as suggested above for the formation of 'District' or 'Zonal' Committees, an all-India machinery should be created for the task of co-ordinating the programme of the District or Zonal Committees, making evaluation of the performance and improving the district plans. Further, such an all-India machinery can carry out special investigations for continuously identifying the nature and extent of spatial, functional and territorial credit gaps in the economy within the overall strategy of economic development. The special all-India machinery which may be constituted for this purpose, may be called the Standing Advisory Committee on Credit Assistance (SACCA) which should consist of senior representatives of the Ministry of Finance, Reserve Bank of India, Planning Commission, nationalised commercial banks and co-operative

banks and borrowers including small borrowers. The primary responsibility of this all-India Committee would be to draw a master plan which would give guidelines for the formulation of district and zonal plans integrating the development of credit and banking with other activities such as production, marketing and supply. The Reserve Bank of India, as the executive arm of this Committee, should provide the necessary secretarial assistance to this Committee and implement its recommendations and watch their compliance. For this purpose, a specialised Department of Credit Planning should be set up in the Reserve Bank of India.

15

Enlarging the Use of the Bill of Exchange as an Instrument of Credit and the Creation of a Bill Market*

A conscious attempt is being made to introduce changes in the lending policies and practices of Indian commercial banks in order to make the most of the limited credit resources available and particularly to enable effective control over the end-use of credit. In this connection, the Reserve Bank introduced in November 1970 a new bills rediscounting scheme which seeks to replace progressively the cash credit system by a system of discounting of genuine trade bills. The report of the Study Group which examined this problem and which is reproduced here throws interesting light on several issues concerning bank credit policies and practices.

Editor

THE SCOPE OF ENQUIRY

The question of creating a bill market in India has been considered on more than one occasion in the past but no

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specific solutions have emerged. The matter was considered by the Indian Banks Association also in 1964 but the Managing Committee of the Association felt that it was not feasible at that time to take any steps towards creation of a bill market in India. The Reserve Bank, however, felt that the question needed to be reviewed again, *inter alia*, in the light of the need to improve the nature of the various instruments of credit and especially in view of the findings of the Study Group appointed by the National Credit Council in October 1968 to look into the extent to which the credit needs of industry and trade were likely to be inflated and how such trends could be checked.

The Group considered the matter from the following angles:

(*i*) Whether in the present and prospective context there is any need for taking deliberate and positive steps to enlarge the use of bill of exchange as an instrument of credit and for the creation of a bill market in India.

(*ii*) If so, what types of transactions lend themselves to

the Reserve Bank of India in February 1970 to go into questions relating to enlarging the use of bill of exchange as an instrument for providing credit and the creation of a bill market in India. The group was composed of the following members:

(1) Shri M. Narasimham, Secretary, Reserve Bank of India, Bombay.

(2) Shri P. Krishna Iyer, Joint Chief Officer, Reserve Bank of India, Bombay.

(3) Shri S.P. Sen Gupta, Chief Officer (Operations), State Bank of India, Bombay.

(4) Shri S.L. Mehta, Asstt. General Manager, Punjab National Bank, Bombay.

(5) Shri C.P. Shah, Joint General Manager, Bank of Baroda, Bombay.

(6) Shri L.C. Mistry, Asstt. General Manager, Union Bank of India, Bombay.

(7) Mr. P.J. Symons, National and Grindlays Bank Ltd., Bombay.

(8) Shri A.K. Bhuchar, Deputy Chief Officer, Reserve Bank of India, Bombay (Convener).

In addition, Mr. H.W. Meserve and Shri Chakravarty of the First National City Bank, Bombay, Dr. A.C. Shah, Economic Adviser, Bank of Baroda, Bombay and Shri A. Raman, Kum. N.K. Ambegaokar and Shri A.L. Batra, all of the Reserve Bank of India were also associated with the deliberations of the Group and they attended some of the meetings.

finance by means of bill of exchange and what steps would be necessary to see that such transactions are so financed.

(*iii*) What institutional set up would be necessary for acceptance and discount of bills of exchange.

In its deliberations, the Group has taken note of two characteristic features of the Indian banking system and the money market. One of these is the predominance of the cash credit system of lending by banks (which accounts for about 70 per cent of the total bank credits). There is no need to go into a detailed discussion of this. Suffice it to say that the Dehejia Working Group has drawn attention to the possibility of misuse to which the cash credit system lends itself.

The other feature is the system of call loans which enable the banks which have excess liquidity to lend to those which are in need of funds. This money is repayable on call and the rates of interest vary from time to time according to the supply of and demand for funds. While in general, the presence of the call money market helps to even out liquidity pressures in the banking system, this is not always the case as indicated elsewhere.

The Group has considered the general question of enlarging the use of bill of exchange for providing credit from the point of view of

(*i*) the Reserve Bank and its control over credit and the money market
(*ii*) the lending banker
(*iii*) the borrower, and
(*iv*) the other institutions.

RESERVE BANK

The framers of the Reserve Bank of India Act did envisage the purchase/discount of bills of exchange by the Bank as a method of providing refinance to the scheduled banks. The necessary provisions in this regard are embodied in section 17 of the Reserve Bank of India Act. However, these provisions have remained dormant and the Reserve Bank has been providing refinance to the eligible scheduled banks (other than against export finance) against usance promissory notes specifically created by their borrowers by converting their borrowings

into usance promissory notes in terms of the Bill Market Scheme. In parentheses we may add that these are not bills in the true sense, nor is there a market for them. It is in effect an accommodation scheme on the basis of improvised bills. This may be attributed to the preponderance of the overdraft/ cash credit system of lending by the Indian banks and the absence of sufficient trade bills which could be rediscounted with the Reserve Bank.

It often happens that at any particular point of time some banks have surplus funds while others are in need of funds. Although the inter-bank call money market provides a means of making the surpluses available to these banks which are in deficit, the banks instead of dealing with one another horizontally, sometimes prefer to borrow from the Reserve Bank to meet their requirements of funds. There are several reasons for this. Firstly, the call money market is not active throughout the country. For instance, surpluses are normally available with the banks in the South and the North where call money market virtually does not exist. Secondly, call money being payable on call, may not be available to banks for use even for short-term commitments. Another reason for this situation is that the State Bank of India keeps out of the market. Consequently. the Reserve Bank tends to become sometimes, the 'lender of the first resort' rather than 'the lender of the last resort'. Thus, while there may be surplus funds in the banking system as a whole, the Reserve Bank may be called upon to provide funds to the banks and through such reserve creation increase the monetary base more than is warranted by the economy's needs at any point of time.

This state of affairs will be corrected to a large extent with the progressive use of the bill of exchange as an instrument of credit as it will then be possible for banks and others with surplus funds to buy bills of various maturities and for those in deficit, to sell the bills in the market to suit their requirements and for eligible banks to approach the Reserve Bank of India only in the event of failing to obtain the requisite accommoda-tion from the market. This will impart flexibility to the money market by evening out liquidity within the banking system and enable the Reserve Bank to exercise more effective control over the money market, as recourse to the Reserve Bank will

normally be only when the banking system as a whole is short of funds rather than when only a few banks are in need of funds as is the position at present. Refinance by the Reserve Bank will, therefore, be related to the genuine need for funds by the banking system as a whole.

There is another advantage from the point of view of the Reserve Bank. In terms of the eligibility provision for note issue, loans and advances to commercial and co-operative banks do not constitute eligible assets. These represent (in terms of the separation of the Issue and Banking Departments) assets of the Banking Department. Consequently, in the busy season, for example, when note issue has to expand and the Reserve Bank of India's lending to commercial banks is the cause for it, it becomes necessary to shuffle other (eligible) assets such as Government securities from the Banking to the Issue Department. If the economy's monetary needs have to be met, keeping deficit financing down at the same time, the Reserve Bank will be faced with the problem of finding eligible assets against currency. Bills rediscounted by it constitute eligible assets for note issue and could provide the necessary contra assets to any extent.

The evolution of the bill market will also make the Bank Rate variations by the Reserve Bank a more effective weapon of monetary control as the impact of any such changes could be transmitted through this sensitive market to the rest of the banking system. There is another aspect to this from the point of view of monetary policy techniques. At present the credit control mechanism of the Reserve Bank of India is built around the operation of commercial banks' access rights to the Reserve Bank and the levy of progressively rising rates as the net liquidity position of the bank gets impaired. With the introduction of a bill discounting scheme, the Reserve Bank of India may give consideration to the problem of adapting its system to the requirements of a bill market consistent with its monetary policy objectives.

LENDING BANKER

As stated earlier, the main method of providing credit at present is by way of cash credit limits. These limits are generally

sanctioned with an accent on security with the result that there may exist the risk of excessive limits being granted in relation to a specified purpose. Further, there is no specific date of repayment of the advance. Also, the assets of a bank representing cash credit advances cannot be readily shifted to another bank in case the lending bank wants liquid funds urgently. No doubt, refinance can be obtained against such advances from the Reserve Bank but advances have first to be converted into usance bills for the purpose. If on the other hand credit is provided by discounting bills rather than by way of cash credit, the amount as also the date of repayment will be definite and it will be possible to meet the requirements of cash easily by rediscounting bills either in the Bill Market or with the Reserve Bank of India.

BORROWER

From the point of view of the short term borrower the advantage would be that in a developed bill market a high class bill of exchange can normally be discounted at rates lower than those charged by banks on advances, the difference reflecting the greater security given to the bill by the signature of an acceptor of high standing and other parties, if any.

In this connection, we invite attention to the observations made by the Dehejia Committee (para. 52). In the case of borrowers who are sellers of goods, some short-term finance is provided by banks for sale of stocks in the form of cash credit against the collateral book debts. This practice may in most cases result in an elongation of the period of bank credit as there is no discipline imposed on the purchasers to pay the dues within a stipulated period. If the practice of culminating credit sales by issue of usance bills is promoted, as suggested by the Dehejia Committee, this would not only impose financial discipline on the purchasers but also help the suppliers or the producers to plan their financial commitments in a realistic manner.

OTHER INSTITUTIONS

The creation of the Bill Market would also enable the other financing institutions and trading bodies to invest their surplus

funds profitably. From the point of view of the banking system and the money market as a whole, there is yet another advantage. At present, some of the larger borrowers are financed by more than one institution on a participation basis, either because the amount involved is very large and beyond the resources of an institution or because the amount is beyond what an institution would like to risk on a single borrower. While these participation arrangements are good insofar as they go, they can create problems to the borrowers, in the sense that they have to go to a number of institutions and conduct parallel negotiations and submit themselves to parallel appraisal of their credit needs by the various institutions. If it were possible to switch over to a system of bills where a single institution lends out the entire requirements by way of bills of appropriate maturities, it should be possible for the institution to enable the other institutions to participate in the finance in an indirect way of purchasing some of these bills of exchange and at the same time avoiding difficulties inherent in a participation arrangement. A system could be devised whereby bills of short-term maturities are taken up by the banks and those of the longer maturities by the term lending institutions. We are aware that some banks are experimenting with a participation certificate scheme in terms of which the primary lending bank sells a participation certificate up to a portion of the advance for a specific period to other banks but these are not negotiable whereas bills would be negotiable instruments.

For the reasons set out above we have come to the conclusion that it would be advantageous to take steps to enlarge the use of bill of exchange as an instrument of credit and to create a Bill Market in the country where bills could be purchased or sold according to the requirements of the institutions concerned.

TRANSACTIONS LENDING THEMSELVES TO FINANCE BY BILLS

Because of the preponderance of the cash credit system of lending and the conveniences which this system provides, there is bound to be some resistance on the part of borrowers to change over to a system of credit based on bills of exchange. The process of evolution is, therefore, likely to take time. We do

not also envisage that it will be possible to replace the existing system of lending by way of cash credit entirely by the proposed system of lending by bills of exchange nor in our view is it desirable to do so. On the other hand, we are of the view that a system should be evolved which should combine the advantages of cash credit system eliminating its deficiencies to the extent possible, and also incorporating the advantages of a system based on bills of exchange. The efforts should, therefore, be directed towards a system where the credit needs of the borrower are met partly by way of cash credit/overdraft limits, partly by way of term loans where necessary and partly by way of bills of exchange.

The next question to which we have addressed ourselves is as to what types of transactions lend themselves to financing by the banking system by way of bills of exchange. A bill of exchange would normally be drawn in connection with the sale of goods or to enable the drawer to raise funds for financing his trading or manufacturing activity. While in the former case it is easy to verify the genuineness of the transaction on the basis of evidence of sale and/or despatch of goods, it is not easy to do so in the latter case. In our view the bill of exchange should be different from accommodation paper where a bill may be drawn to enable the drawer to raise funds (ostensibly for his trading or manufacturing activity). We, therefore, feel that it is necessary to limit any proposed scheme for bill finance only to genuine trade bills; in other words, to bills which evidence sale and/or despath of goods.

The entire basis of acceptability of bill of exchange by a discounting agency is that it should contain at least one good signature other than that of the drawer. In normal course, the bill would be drawn on the purchaser of goods who would accept it. However, at the present moment, there are no agencies in the country similar to those operating in U.K. and U.S.A. which specialise in credit investigation or perform purely acceptance business. In the absence of such agencies, if may not be possible to check the creditworthiness of the acceptor of the bill. This difficulty can be obviated if the bankers of the drawee (purchaser) also put their signature as endorsers or guarantors on the bill. This would, however, mean that the bill, before it becomes acceptable to the Bill Market, will have to

be sent to the purchaser for acceptance, who, after acceptance, would arrange for it to be endorsed by his bankers. As the seller and the purchaser are quite often in different places, this process will involve delay. This delay could be avoided if arrangements could be made whereby a bank of standing at the place where the seller is stationed, would accept the bill on behalf of the purchaser of the goods. This could be done if the purchaser's bankers grant him acceptance facilities at the office situated in the place where the seller is stationed. It is realised that under such an arrangement, the signature of the buyer of the goods—who should really be the drawee of the bill and hence the acceptor—will not appear anywhere on the bill and he will not, therefore, be liable *on the bill*. His liability to his bankers would be on the basis of the agreement that he may have entered into with them for the acceptance facility. If he fails to remit in time sufficient funds to his bankers to meet the payment of the bill on the due date, the bankers will not be able to sue him on the bill but will have to rely on the documents which they might have obtained from him. The advantage which a bill of exchange has, viz., that the parties thereto may be summarily sued for payment, will be lost to the bankers who have given the acceptance facility. Considering, however, the fact that the acceptance facilities will be given only to first-class parties and after the bankers have satisfied themselves as to their ability to meet, on due dates, the payment of the bills, we consider that the risk, if any, will be very small. In view of this and having regard to the fact that the process would be much quicker and more convenient from the point of view of the seller, we recommend that the bills of exchange for the purpose of the Bill Market Scheme envisaged in this Report should bear the signature of a licensed scheduled bank as an acceptor (The term licensed scheduled bank for the purpose of this Report will also include those banks which do not require a licence). There is no objection to any bill so accepted being purchased by any bank or others. However, we recommend that, for the present, only such bills should be eligible for rediscount by the Reserve Bank of India as are accepted by licensed scheduled banks and are offered by such banks to the Reserve Bank for rediscount. We also recommend that in order to keep accommodation bills out of the market, efforts should be

concentrated, for the present, on financing by means of bills of exchange transactions relating to sale of goods only. Such bills should normally be of a usance not exceeding 90 days but may in exceptional cases have a usance upto 120 days. In any event, as far as rediscount facilities from the Reserve Bank are concerned, such facilities are available only in respect of bills which have to run for a period not exceeding 90 days at the time these are offered for rediscount (except in the case of export bills which may run up to 180 days).

From a long-term point of view, we would like to draw attention to the need for exploring the possibilities of setting up a credit investigation agency to which the banks and other institutions could turn up for up-to-date credit information on various parties. We also believe that as the business expands there may be a case for specialised acceptance houses being set up in addition to acceptance business being undertaken by banks.

We have considered whether there will be a sufficiently large number of bills of exchange available to feed the market if financing by bills is for the present confined mainly to sales transactions. The matter has to be viewed in the context of the situation as it exists to-day and as it is likely to arise in future. With the increase in agricultural and industrial production, we envisage that credit sales are bound to increase in the coming years, necessitating an increasing resort to the banking system to finance such sales. No data are readily available as to the extent to which the banks are at present financing the book debts of their borrowers. But it can be safely assumed that during the last few years such credit has been increasing. We are, therefore, hopeful that in course of time sufficient bills of exchange arising out of sale of goods and commodities will be available to feed the Bill Market. This apart, it is not the intention to restrict the market to these bills only. Therefore, we envisage that bills arising out of import and export of goods or those which are eligible for rediscount with the Industrial Development Bank of India under its Rediscounting Scheme but are not rediscounted with that Bank may be additionally available to the market.

We do not at the same time underrate the impediments that stand in the way of creating a Bill Market. As stated earlier,

there is bound to be some resistance on the part of the borrowers to borrow by way of discount of bills of exchange rather than against book debts. We also envisage that there will be resistance on the part of buyers of goods to accept the bills of exchange drawn on them by the sellers in connection with the sales, or to ask their bankers to accept such bills on their behalf, as this would bind them to make payments for the purchases on the stipulated dates. There will also arise the question of cost of stamp duty on the usance bills. But we are satisfied that the proposed reform is worthwhile and that ways and means should be found for overcoming the difficulties which may arise rather than abandoning the scheme itself. We accordingly, suggest that in the first instance, the banks or the Indian Banks Association should educate their borrowers and try to persuade them to avail themselves of finance necessary for sale of goods on credit by way of discount of bills of exchange. In case persuasion does not yield results, the Indian Banks Association may discuss the issue with its members and they may come to an agreement that they will charge higher rates of interest or stipulate stiff margins to discourage borrowings against book debts. Should these efforts fail to yield the desired result, we recommend that the Reserve Bank of India may consider issuing appropriate advice or directive to the scheduled commercial banks in order to discourage them from lending against book debts.

A question which has arisen in this connection is as to how to bring about the financing of transactions relating to sale of goods by way of bills of exchange without at the same time diluting the credit control measures of the Reserve Bank of India in relation to the commodities which are covered by such controls. At the moment, these controls operate in relation to the total permissible limit of advances by individual scheduled commercial banks in relation to specified commodities, the stipulation of a minimum margin in relation to such advances and the stipulation regarding minimum rates of interest in certain cases. If sales transactions relating to these commodities are not excluded from the purview of financing by usance bills of exchange we apprehend that it might be possible for the borrower to circumvent the provisions of the control by converting the advances against such commodities into usance

bills of exchange. We, therefore, recommend that the scheme should exclude bills of exchange arising out of sale of such commodities as may be indicated by the Reserve Bank of India from time to time.

In order to ensure this, we suggest that the usance bills of exchange should provide a clause indicating the nature of transactions out of which the bill has arisen. To give an illustration, a bill of exchange arising out of sale of X bales of cloth may contain a foot note to the effect that it has arisen out of the sale of X bales of cloth covered by Railway Receipt No....dated...... It may be mentioned here that it is the practice in U.K. to put a clause on the bill of exchange indicating that the bill has arisen out of sale of specified goods/ commodities and also to state the name of the carrier of the relative goods.

We have also considered whether the Government supply bills can be brought within the purview of the scheme. These bills are not at present drawn in the form of bills of exchange but are mere claims on Government for the supplies made. If a procedure can be devised whereby bills of exchange can be drawn on Government departments for obtaining payments in respect of supplies made to them, this could be a substantial source of eligible bills for the market. However, the difficulty which we envisage is that once the Government accepts a bill of exchange, it will be bound to pay it on the due date. At present, the Government reserves to itself the right to adjust the proceeds of a bill against the amounts due to it by the concerned supplier on other transactions. This advantage will also be lost to Government if bills are drawn on them by the suppliers in the form of bills of exchange. However, if Government can be induced to accept bills of exchange for the supplies made to them up to a portion of the amount due, say 75% to 80% and at a stage when an inspection note for the supplies is available, there would be no great risk to Government in accepting such bills which would then be available to the market for purchase or discount. As realisation of the bills on Government at present generally takes a long time, a grievance of the contractors and the inconvenience caused to them because of the delay would also be mitigated. We accordingly recommend that the Reserve Bank of India may take up the matter with

the Director General of Supplies and Disposals on the lines proposed above.

A relevant question which arises is whether any limitation should be placed on the aggregate amount of acceptances to which a bank may commit itself. We recommend that the Reserve Bank of India may consider whether it is necessary to place limitations on the total acceptances by individual banks and take such action as is considered appropriate.

One of the deterrents in the way of development of a Bill Market in India has been the stamp duty on usance bills and suggestions have been made in the past to abolish or reduce such duty. The rate of stamp duty at present for 90 days usance bills is 50 paise for Rs. 1000 (i.e., 0.05%). Since we envisage that the rate of discount charged to the borrower will be lower than the rate on other types of borrowings, we feel that the additional cost on account of stamp duty may be borne by him or passed on to the other party to the transaction.

INSTITUTIONAL SET-UP

We have also gone into the question of institutional set-up necessary for the purpose of accepting and discounting of bills of exchange. We have suggested earlier that for the present, the bills of exchange to be brought within the purview of the scheme as envisaged in this report, should be accepted by licensed scheduled banks. The discounting of bills will be either by banks or others who may be interested in short-term investments. We, therefore, consider that it may not be absolutely necessary at this stage to create separate acceptance or discount houses under official auspices. However, there will be need for intermediaries who may act as a link between the sellers and purchasers of bills. This role can be taken up by bill brokers. They will function primarily as agents for the sellers or buyers but occasions may arise when they may have to take up bills on their own account instead of acting merely as brokers. They can do so either out of their own funds or by taking short-term accommodation from banks. In order to ensure that they have the requisite standing, we suggest that the Indian Banks Association may draw up a list

of approved brokers for this purpose. We also feel that to begin with efforts should be concentrated to create Bill Market at the four main centres of the country namely, Bombay, Calcutta, Madras and New Delhi.

Although we have come to the conclusion that it is not necessary at this stage to create separate acceptance and discount houses, if efforts were made in the direction of setting up separate acceptance/discount houses or merchant banking divisions, the Reserve Bank of India should extend its support and consider accepting the signatures of such specialised institutions as a good signature.

The licensed scheduled banks at present obtain refinance from the Reserve Bank against usance promissory notes specially created by converting the borrowings of their clients. While the Reserve Bank of India would, if our proposals are accepted, be in a position to rediscount genuine bills of exchange, as the amount of such bills eligible for rediscount may not in the initial year, be sufficient to enable banks to obtain their requirements of funds from the Reserve Bank, we suggest that the present Bill Market Scheme may also continue for the time being but it should be gradually replaced by the proposed scheme of rediscounting of genuine bills.

We also recommend that the Reserve Bank may exempt as is done now in respect of D/A bills, the bills discounted by banks as envisaged in this report from the norm relating to clean advances and may also examine what further relaxations/exemptions from the various norms are necessary to encourage banks to lend progressively on a larger scale on the basis of bills of exchange.

We have considered the effect of our proposals to create a Bill Market on the future of Inter Bank Call Money Market. The Bill Market envisaged by us is not intended to supplant the Inter Bank Call Money Market but is designed to function as an auxiliary to it and thus to meet some of its deficiencies and improve the functioning of the money market. The Call Money Market will continue to play its role in meeting the needs for overnight and call money arising from adverse clearing and similar other short-term factors.

The Group would like to place on record its high appreciation of the valuable assistance it has received from

Sarvashri A. K. Bhuchar and A. L. Batra of the Department of Banking Operations and Development, Reserve Bank of India, Bombay in the discussions and in the preparation of the draft report.

16

What is a Development Bank*

William Diamond

This essay gives a bird's eye-view of the diversity of forms which development finance institutions have taken in different countries. It also underlines the diversity of purposes which such institutions are expected to fulfil.

Editor

In the past 25 years, the governments of an increasing number of underdeveloped countries have created or have promoted the organization of 'development corporations' and 'development banks'. Those institutions have taken forms so diverse that, despite frequent similarity of formal title, they often have little resemblance to each other and often have little in common. Among them are such different institutions as the Etibank of Turkey, created to exploit mineral resources and to build power plants on behalf of the Government; the Corporación de Fomento de la Producción of Chile, created to draw up and carry out a general plan to promote production in all sectors of the economy and to obtain credit from abroad; and the Industrial Credit and Investment Corporation of India, established to provide long-term finance to private industry. Although all such institutions have been sponsored by governments, which exert a varying degree of influence on their policies and operations, some are owned exclusively by government, others by private interests and still others by a combination of the

*Taken from William Diamond, *Development Banks*, The John Hopkins Press, Baltimore, 1957, pp. 1-5. Reprinted by permission.

two. Some are devoted to the promotion and financing of government enterprises, others exclusively to private investment and still others act in both fields. Some have broad planning functions, some can only lend, some can lend and take equities and some can set up and manage enterprises on their own account. Some are concerned with the entire economy, others with but a single sector. Some are regional, others national. Ownership, sources of finance, degree of dependence on government, objectives and methods of operation differ over a broad range of possibilities.

A distinction is often made (by the United Nations, for instance) between a 'development bank' or 'finance corporation', defined as an institution 'concerned primarily with long-term *loan* capital', and a 'development corporation', which is 'concerned primarily with *equity* capital' and with 'fostering and managing specific companies as well as providing financial support'. This distinction may be conceptually valid but is usually too blurred to be useful in practice. In some cases, banks or corporations created to invest in both loans and equity have gradually moved, in their actual operations, to one or the other end of the spectrum; and others, created to serve one purpose, have evolved in a quite contrary direction, as a result of changing circumstances or shifting government policy. Moreover, in the area between outright debt and common shares lies a broad range of useful investment possibilities. All those possibilities can be of great importance in the stimulation of a capital market, which is another objective of many development banks.

Although the distinction between loan-providing development banks and equity-providing development corporations may be blurred, it does help to point up the two objectives common to virtually all such institutions: the provision of capital and the provision of enterprise[1] when either or both of those requisites of economic growth is thought to be lacking. Though the emphasis may sometimes be on one and sometimes on the other, the purpose of setting up a development bank or

[1]The term 'enterprise' will appear frequently hereafter and it would be well to say now what it is intended to mean. Much has been said and written about 'enterprise' and 'entrepreneurs' and many distinctions have been drawn between the various guises in which they appear, the

corporation is usually to supply these two factors of production in order to speed up the process of development.

There is another, more useful line that can be drawn in considering development banks: between those concerned with government investment and those concerned with the private sector. In some countries, governments have decided that the government itself should—or that only it could—fill the gaps of capital and enterprise required for the creation of new productive facilities. Those governments created institutions to plan, finance and carry out investment projects or programmes on government account. Thus the Soviet Prombank, concerned with the long-term financing of industry, is the channel through which budgetary appropriations and other planned allocations of funds are made available to state enterprises. The Sümerbank of Turkey concentrated on establishing, financing and managing industrial enterprises on behalf of the government. The *Corporación Boliviana de Fomento* devoted itself largely to financing highway construction and a government-owned petroleum production authority. The development banks in underdeveloped countries established in earlier years were often primarily agents for executing government investment projects. Some were also given responsibility for 'planning' economic development, presumably in order to remove 'planning' from direct political influence, shield it from administrative instability and free it from bureaucratic red tape. It is interesting to note that some of the institutions which were given such broad functions did no

functions they perform and the conditions under which they thrive. For some purposes such distinctions may be important and useful. However, for the discussion of development banks in the present context, they are unnecessarily fine. It should be sufficient to rely on Noah Webster. 'Entrepreneur' is defined as 'one who assumes the risk and management of business'. 'Enterprise' is defined as 'an undertaking, especially one which involves activity, courage, energy or the like; an important or daring project; a venture' and as 'the character or disposition that leads one to attempt the difficult, the untried, etc.'. In short, enterprise (when not used in the simple sense of an undertaking) involves the willingness to assume risks in undertaking an economic activity, particularly a new one, though not necessarily an unknown one. It may involve an innovation, but not necessarily so. It always involves risk-taking and decision-making, although neither risks nor decisions may be of great significance.

in fact carry them out and have gradually lost them or given them up to other agencies of the government.

These institutions sometimes reflected an ideological or dogmatic attitude towards the role of the state in economic activity generally or in particular fields, and sometimes reflected the pragmatic conclusions drawn from the circumstances of the country. In either event they were not primarily investment institutions. The decision to create them centered on the question whether state enterprises should be established within the normal governmental organization or as separate and autonomous entities—on the desirability of establishing a government corporation to carry out certain governmental responsibilities rather than discharging them within the regular departmental framework. The problems raised by the decision to take such functions out of routine government departments are not problems of entrepreneurship or of financing but of governmental organization and administration. Such problems—how to assure responsibility to the legislative and executive arms of the government and to the public while maintaining operational independence; the role of the government in the decisions of the institutions; coordination with other government agencies, etc..—may also be important problems for some types of development banks.

It is not with such institutions as these—devoted exclusively or chiefly to the creation or financing of state enterprises—that this essay is concerned. A development bank, as that term is used here, is a financial institution devoted primarily to stimulating the private sector of the economy. This is not to say that institutions of the former type do not contribute to the development of the private sector. Thus, for instance, the Sumer and Eti Banks of Turkey, as a by-product of their activities, have helped to create a reservoir of skilled labour and managerial experience which has been of immense value in the development of private industry and have, indeed, provided some of the top personnel of the Industrial Development Bank of Turkey. But most development banks have been set up as catalysts for investment in the private sector, to provide injections of capital, enterprise and management, not as administrative devices to handle the governments' own investments. Such institutions were designed to be means of mobilizing resources and skills

and of channelling them into approved fields under private auspices rather than into the public sector. Their functions are much more closely akin to those of the investment banking institutions of advanced countries, although they are intended be be pump primers rather than simply conduits for the factors of production and they usually have to perform a greater variety of functions. This kind of institution can make a contribution to development wherever a private sector exists and particularly where opinion and policy hold that economic development depends ultimately on broadly based initiative, managerial ability and technical skills and on the opportunity to exercise them, and whenever those characteristics are in short supply.

The development bank, defined as an institution to promote and finance enterprises in the private sector, is not a new device. Institutions to mobilize capital and to promote productive investment have existed for more than a century. They exist today in countries as diverse in background and circumstances as France, Chile, Puerto Rico, Turkey, India, Great Britain and Indonesia. The recent upsurge in their popularity in Asia, Latin America and Africa and the increasing effort to make them more effective instruments of economic development may sometimes appear to be slavishness to a new fashion. But these institutions are in fact a reflection of the growing urge for rapid economic development and of the search for machinery to use where development does not appear to be proceeding of itself with the desired speed. This was the position of continental Europe, as it looked on Britain in the middle of the nineteenth century; it is the position of most of the nations of Latin America, Asia and Africa today, as they look on Western Europe and North America. In the former context the prototypes of the development bank appeared as a financial innovation, with results of crucial importance to the development of several countries. In the latter context that institution is being adapted to new circumstances with hope of similar results.

17

The Creation of Lending Institutions*

Edward Nevin

This essay examines the need for creating development finance institutions and the problems of their organisation and working. It is inescapable for the government to play a crucial role in the creation of these institutions. The author discusses in this context the impact of government's socio-economic policies—specially policies towards agriculture and small business—on the working of these institutions. He also stresses that the effectiveness of the lending programme in the circumstances of underdeveloped economies would often require that the provision of finance should be accompanied by proper advice, information, general investment consultancy, and control over business practices.

Editor

THE NEED FOR LENDING INSTITUTIONS

In the more highly developed economies of the world, specialised saving and investment institutions are a familiar feature. Over a period of years the forces of market evolution have resulted in the establishment of institutions concentrating on

*Taken from Edward Nevin, *Capital Funds in Underdeveloped Countries*, Macmillan & Co. Ltd., London, 1961, pp. 72-86. Reprinted by permission of Macmillan London and Basingstoke.

either the collection of investible funds from a variety of sources or the disposition of such funds between various outlets. The advantages of specialised institutions of this kind are well known. In the first place, the channelling of savings through them, rather than direct investment in productive enterprises by individual savers, enables funds to be collected from a wide range of different sources, each of which could individually account only for sums which would be too small for worthwhile investment, or whose investment would be so costly as to make the effective rate of interest unduly high. In modern times, the amalgamation of these relatively small individual flows from a large number of separate sources can result in substantial aggregations of funds; it is likely that much of this flow would have been lost to useful investment without some medium through which the small saver could dispose of his funds cheaply and safely. In the second place, and related to this, these institutions enable the investor to spread his risks in a way which would not have been possible if all investment had to take place directly. The placing of funds in an investment trust, for example, in effect enables the holders of small amounts of capital to distribute their funds over a wide range of industries and enterprises, and this distribution achieves a significant reduction of the risk to which capital is exposed in the course of investment in industry.

On the investing side equally there are advantages to be gained from the allocation of capital between different sectors by institutions specialising in particular types of credit. The disposal of funds in manufacturing industry, in housing, in government securities or in foreign assets all involve their own different types of expertise; it can naturally be effected with considerably greater efficiency by institutions with long experience of a narrow range of investment outlets than by an individual investor with no specialised knowledge of any. Hence the growth of various types of lending institutions such as building societies specialising in housing credit, agricultural banks specialising in farm credit, finance houses specialising in consumer credit, merchant banks specialising in the channelling of capital to particular types of industry and particular branches of trade, and so on. In both the collection and the distribution of investible funds, then, there exist economies of specialisation

comparable with those obtainable in productive processes in industry or agriculture.

In most industrial economies these institutions have evolved through the normal processes of market pressure, and have acquired their organisation and functions only after a long period of development and experiment. It is true to say that in exceptional cases, where marginal needs have not been met, official agencies have often been established—or private institutions established with official support and encouragement—in order to fill some particular gap in the credit structure. These agencies are exceptional in that they usually provide only a small proportion of the total volume of credit flowing from savers into investment; in general they have been established to deal with sectors of the economy where the risk, expense or difficulties of administration have been such that the private institutions dealing with the bulk of the credit flow have proved unwilling to extend their activities into them. Just as a privately-owned electricity supply system, left to itself, will not usually extend its services into areas where population is thinly spread over relatively large distances, so private investment institutions have found certain areas of the economy of such difficulty or peculiarity as to create expectations of only small profit, or none at all. In general, it is only to fill the gaps resulting in this way that official institutions have been set up in the world of investment finance.

The significance of all this for the underdeveloped economy is fairly clear. In the first place, the pressure of poverty in them is so intense (and the vulnerability of popularly elected government so great) that the need for specialised agencies for the finance of investment cannot safely be left to the processes of slow evolution. What in earlier generations could have been allowed to develop over scores, if not hundreds, of years must now of necessity be created in a much shorter space of time. Secondly, the sectors of the economy where conventional profit expectations are highly uncertain, or relatively low, are not so much exceptional as customary. In a highly-developed industrial economy official agencies are needed only for marginal and relatively unimportant fragments of the economy, profit expectations in the major part of the system being sufficiently powerful to stimulate an adequate amount of privately-financed

activity; in the underdeveloped economy, on the other hand, the reverse is the case. Certain limited sectors of the economy (typically the export of primary produce) will hold out sufficient profit expectation to ensure that adequate finance is forthcoming from banks and other sources; for the rest of the economy, however, profit outcomes are so uncertain and far-distant that private capital is reluctant to flow into it of its own volition.

In a word, an economy is under-developed precisely because the greater part of its productive capacity has not proved an attractive investment for private funds; institutions to channel funds into those sectors have therefore failed to evolve from the spur of ordinary market forces. Hence if the savings available to the community—and such other funds as it may be able to obtain from abroad—are to be used so as to attain maximum growth in the economy, the institutional framework to assist and stimulate the flow must be deliberately created and supported by the government of the territory concerned.[1] To leave this task to unassisted market forces is to incur a serious risk that it will not be performed except after intolerable delay.

The Role of Lending Institutions in an Underdeveloped Economy

The tasks of financial institutions in an underdeveloped territory are therefore almost self-evident. In the first place, their purpose is to provide a collecting point for savings of a relatively small average amount from a large number of individual sources. So long as the means to utilise savings safely and profitably are not available within an economy, funds will either be diverted abroad, sterilised in useless hoards of cash or precious metals, or, more likely still, will not accumulate at all.[2] However poor an economy may be there will be a need for institutions which allow such savings as are currently forthcoming to be invested conveniently and safely, and which ensure that they are channelled into the most useful purposes. The

[1]The importance of this is stressed heavily in the United Nations report *Methods of Financing Economic Development in Underdeveloped Countries*, pp. 3–8, 74–75, and 92–93.

[2]On this last possibility see Lewis, op. cit., Ch. V, p. 229.

poorer a country is, in fact, the greater is the need for agencies to collect and invest the savings of the broad mass of persons and institutions within its borders. Such agencies will not only permit small amounts of savings to be handled and invested conveniently but will allow the owners of savings to retain liquidity individually but finance long-term investment collectively.

The second point follows closely from this. Given the high degree of risk inherent in investment in an economy of the kind under discussion, it may prove essential that the institutions established to collect and invest the savings of the community should be supported by a guarantee of its government just as public utilities in industrialised countries are financed with the aid of government guarantees. It is inherent in an underdeveloped economy that the risk attached to investment in local enterprises is large; private individuals cannot reasonably be expected either to assess the extent of this risk fairly, or to take it entirely on their own shoulders. It is a proper function of government in such circumstances to provide some guarantee against these risks; it is the only organisation which is able to spread its own risk over the entire economic life of the community, and it is in fact the only part of the system whose function it is to accept the uncertainties inherent in the development of the economy as a whole.

A third important function of the framework within which savings flow from individuals to enterprises is that the specialised institutions can ensure that proper advice, guidance, information and general investment consultancy accompanies capital wherever necessary. It is generally beyond the responsibility or means of a purely private institution to take upon itself the function of ensuring that enterprises utilising its funds are adopting proper methods of accountancy, production techniques, marketing arrangements and so on. Yet control of these matters is an essential part of the investment process in an underdeveloped economy: it is crucially important that when capital is invested in an enterprise such measures as are humanly possible are simultaneously adopted to ensure that it will be used properly and efficiently. Underdeveloped economies can not afford the luxuries of capital wastage and over-employed bankruptcy courts. Only a relatively large-scale and disinterested

agency can be expected to provide these services and to make them generally acceptable, however, and it is therefore a highly desirable function of investment institutions in an underdeveloped economy to secure and administer management consultancy of this kind—in the words of the Central Bank of Rhodesia and Nyasaland, to provide 'both ante-natal diagnosis and after-care'.[3]

Finally, the creation of development finance institutions can make a contribution to the solution of the general problem of ensuring that scarce supplies of capital are distributed in accordance with the best interests of the development of the economy as a whole. A private institution, must naturally be guided in making its decision by the profitability of different avenues of investment over the reasonably near future. But it hardly needs to be argued that the resulting pattern of investment may not coincide with that allocation of resources which is conducive to greatest long-run expansion in the economy. A central lending institution allocating investible funds becoming available from private and official sources is therefore a fundamental necessity in an economy where capital is so extremely scarce, and where the need for growth so pressing, that the wastage of capital in terms of the best economic development of the community cannot be tolerated.[4] This by no means implies that the financing of investment needs to be barred altogether to private initiative; it does imply, however, that a central agency disposing of a substantial proportion of the

[3]Bank of Rhodesia and Nyasaland, *The Financing of Economic Development in the Federation of Rhodesia and Nyasaland*, Salisbury, May 1959. See also Diamond, op. cit., pp. 57–60. Examples of the dismal consequences which can follow from the absence of such supervision may be found in W.A. Lewis, *Report on Industrialisation and the Gold Coast*, Government Printer, Accra, 1953.

[4]United Nations experts favoured the creation of special agencies for the disposition of public capital funds to the private sector, but mainly on the ground that official administrative machinery was not well suited to the direct investment of such funds—*Domestic Financing of Economic Development*, pp. 44-45. In recent years the I.B.R.D. has actually encouraged borrowing countries to establish development banks for the specific purpose of assisting industrialisation—preferring, however, that they should not be government agencies. See A.K. Cairncross, *The International Bank for Reconstruction and Development*, Essays in International Finance No. 33, Princeton University Press, Princeton, New Jersey, March 1959, pp. 22–23.

total capital flow will be necessary to augment and complement the work of private investors.

It would not be appropriate in an essay of this kind to attempt to discuss the detailed form of organisation which development finance institutions should adopt.[5] In general it may be said that the balance of advantage will probably lie with a separation of the two functions of collecting investible funds, on the one hand, and their investment in specific enterprises, on the other, into two distinct institutions. The former function is best left to organisations specifically designed to meet the peculiar circumstances of the country concerned—official or semi-private savings banks, insurance companies, thrift and provident societies, etc.—which could transmit funds to the lending agencies by taking up securities issued by the latter or through the medium of the public debt, a subject discussed in the following chapter. Little need be said about the collecting agencies by way of detail, therefore; their form will depend almost entirely on the individual characteristics of each territory, and their number will naturally depend on the magnitude of the potential flow of funds.[6] (It is scarcely necessary to add that the practice whereby a large—perhaps the greater—part of the assets of official Savings Banks in many Commonwealth countries are invested overseas obviously requires modification).

Just as commercial banking control and inspection is usually desirable in underdeveloped countries to prevent the growth of unsound banking institutions, central banks in territories of this kind will probably find it necessary to require other institutions inviting deposits from the general public to be registered with it and to observe general regulations concerning capital structure, liquidity, management, reserves, etc., laid down with legislative force. One or two points of principle concerning

[5]Those wishing to examine the detailed problems involved in designing institutions of this kind are well served by two excellent studies published under the auspices of the I.B.R.D.: W. Diamond, *Development Banks*, John Hopkins Press, Baltimore 1957, and Shirley Boskey, *Problems and Practices of Development Banks*, John Hopkins Press, Baltimore 1959. A somewhat more critical survey of several development banks is given in Hanson, *op. cit.*, Chaps. VII and VIII.

[6]On this subject see *Domestic Financing of Economic Development*, United Nations, New York 1950 (1951. II. BI), pp. 16–20.

the policy of agencies responsible for the disposition of funds amongst individual investment projects, however, are discussed in the following sections.

THE OWNERSHIP OF DEVELOPMENT FINANCE INSTITUTIONS

The decision as to the location of ultimate control of a financial institution concerned with the channelling of funds into predominantly private enterprises is a matter which will be decided primarily on political rather than economic and financial grounds. Nevertheless, it seems clear that in an underdeveloped economy the normal considerations which would apply to the ownership of institutions of this kind in a developed industrial economy lose much of their force. By definition, the need for specialised institutions arises because under the prevailing circumstances the profit mechanism cannot be expected to result in the optimum allocation, or even the maximum encouragement, of the savings of the community. Although funds may be invested predominantly in privately-owned enterprises, the essential aim of the institutions is to ensure that financial resources are used in a manner consistent with the long-run interests of the development of the community, and it is difficult to argue that responsibility for that development can be divorced from government.

If governments assume responsibility for drawing up, in some sense, development plans for their countries, the distribution of resources by development finance institutions can be in full harmony with these official plans only if the institutions have clearly decided that the criteria to be adopted in deploying funds are those accepted by their governments, rather than those which would arise from consideration of commercial profit and loss. Because the unassisted profit mechanism does not work adequately and satisfactorily in an economy of this kind, a development finance institution can operate effectively only if it is in such close touch with its government as to make private control of it largely illusory in substance if not in form.[7] One detailed

[7]A related consideration given heavy stress by the United Nations experts is that official control will also be needed to ensure that borrowing from the market for various investment projects takes place in an

survey of the experience of such development finance agencies has concluded that they

> normally cannot be established on a sound financial basis unless the government is prepared to extend generous financial support.[8]

And it would scarcely be reasonable for any government to be expected to provide 'generous financial' support without a substantial degree of control over the uses to which public funds were being put.

Another consideration leading to the same conclusion is that a major function of this type of institution must be to provide a suitable outlet for the funds accumulated by official and semi-official bodies such as the central bank (including currency reserves), official Savings Banks, and even commercial banks operating in the territory. The investments held by institutions of this sort must of necessity be extremely high-grade and of the kind commonly described as gilt-edged. That is to say, they must be government obligations or something close to them. In any case, as was noted earlier, the granting of a government guarantee to the liabilities of such an institution is almost certain to be highly desirable, if not essential.[9] Another comprehensive survey of the experience of development finance institutions throughout the world has affirmed that

> while some development banks have been successful in raising funds in domestic bond markets, the success of many has undoubtedly depended either on their official position or on official support.[10]

But if, for example, a government guarantee as to the capital sums invested in such an institution is to be given, it is not easy to see how it could be reconciled with any really effective degree of private ownership of the institution. Private ownership would

orderly and co-ordinated manner, *Domestic Financing of Economic Development*, pp. 47–49.

[8]Boskey, op. cit., Ch. 1, p. 8.

[9]For example, the bonds issued by the industrial development corporation of Mexico carry a federal guarantee, and are virtually government issues. On the other hand, such guarantees are not normally considered necessary for the issues of similar corporations in Puerto Rico or India, even though their capital is subscribed by the government—ibid., p. 49. See also Cairncross, *Banking in Developing Countries*, p. 91.

[10]Diamond, op. cit., p. 68.

imply at least a possibility of conflict between the policy of the government and that decided upon by private share-holders; if such a conflict is possible, it is difficult to envisage how a government could enter into a guarantee concerning the capital invested in the institution.

Another important function of the institution will be the attraction of external capital; the supply of investible funds within an underdeveloped territory is seldom adequate to meet the full possibilities of its investment programme. Once again, the achievement of this end is not always as easy to reconcile with private ownership as it might be in a richer and more advanced economy. Investment in an underdeveloped territory by foreign investors has such a high degree of risk subjectively attached to it that it is unlikely that private investors, or even foreign public investors, would willingly commit funds to an institution of a purely private kind, its obligations might be defaulted upon, and its operations must inevitably be liable to governmental control in a way which might be regarded as adverse to the interests of the foreign investor.[11] The history of international capital movements in recent decades suggests that capital will generally be invested in private enterprises (other than those which are foreign-owned) in underdeveloped territories only on such conditions as to make the process distinctly expensive or onerous in other ways from the borrower's point of view. The risk inherent in investing in the private enterprises of a foreign country are such that this must almost necessarily be the case. To the foreign investor, the liability of the government of another territory to interfere arbitrarily with externally-owned capital assets is always so real a threat (and to be honest, the attitude is not without some justification in the light of past

[11]The Articles of the International Bank of Reconstruction and Development, indeed, *require* that loans to private borrowers must carry a governmental guarantee. Nevertheless, when encouraging the establishment of development banks, the Bank insists that wherever possible such agencies should be private corporations or have private representation on their Boards. This is not an inflexible rule however; I.B.R.D. loans have been made to government development agencies in the Netherlands and in Ethiopia—Cairncross, *The International Bank for Reconstruction and Development*, pp. 22–23.

experience) that the flow of capital is inevitably restricted.[12] Only a government guarantee of sufficient extent and duration to take care of considerations of this kind can hope to stimulate the flow of foreign capital into the territory, and this sort of guarantee would in general be so far-reaching in its implications as to make a substantial degree of official control of the policy of the institution concerned a practical necessity, whatever the institution's form of ownership.[13]

AGRICULTURAL CREDIT

In principle there would be a great deal to be said for the creation in an underdeveloped territory of a single development finance institution charged with the allocation of its supplies of credit to all sectors of the economy, whether privately-owned or otherwise, and with the administration of all the capital funds which could be made available to it for investment by either the government, through its current revenue surplus, or private savers and institutions in the territory. In the first place, the creation of the single institution would ensure that administrative skill and talent was concentrated and not dissipated over several competing institutions. In the second place, the granting of a virtual monopoly of the credit available

[12] *Measures for the Economic Development of Underdeveloped Countries*, Ch. XI, paras. 257–58, p. 81.

[13] However, some governments have chosen to make institutions of this kind wholly privately-owned, although sometimes (as in the case of the Rhodesia and Nyasaland Development Corporation) giving a guarantee in respect of its external borrowing. Presumably the advantages of government control summarised in the text were not thought sufficient in these instances to overcome a political disinclination to involve the government in the affairs of private enterprises. As Diamond puts it, prime importance is attached to 'the independence of the management of the institution from pressures both private and bureaucratic' (op. cit., p. 61); similarly the I.B.R.D. view is simply that 'industrial development is best left to private enterprise' (Cairncross, *The International Bank for Reconstruction and Development*, p. 23). Clearly, there are some nicely-balanced considerations here, but it is difficult to see how both a complete integration of investment policy *and* independence of management can be achieved. Each government has to decide for itself, which of these two *desiderata* is to be given priority. The point is fully argued by Diamond, op. cit., pp. 70–76.

from sources other than the established institutional investors (e.g., the commercial banks or insurance companies) would help towards the familiar aim of ensuring that scarce supplies of capital were allocated between broad economic sectors, and between marginal enterprises in different sectors, in a logical and consistent fashion. If the need for capital was greater in one sector than another, an institution controlling a substantial part of the total supply available could ensure that the disposition of funds was adjusted accordingly.

It would follow from this that the government of an underdeveloped territory seeking to stimulate the collection and investment of the savings available would be well advised to create a single development finance institution, carrying its guarantee, controlled and administered by directors nominated by it, and drawing up its policy in close consultation with the organs of government responsible for the formation of overall economic policy. Such an institution might well become the major single source of capital outside the banking system for all enterprises in the agricultural, mining, manufacturing and commercial sectors. Nevertheless, there are serious disadvantages in having a single institution of this kind to provide finance not only to the broad range of manufacturing industry but to special categories such as agriculture, small businesses, and commercial organisations.

The case of the last of these can be disposed of briefly. By and large, the finance of trade is not a problem in underdeveloped territories; indeed, one of the major complaints which can be laid at the door of the expatriate commercial banks is precisely that they have over-supplied the commercial sectors of the economy with credit, concentrating on financing foreign or internal trade transactions and neglecting indigenous industry. Furthermore, the finance of commercial transactions is a function which does not go easily with industrial investment. It is more than mere accident that in the highly developed economies of the world it is usual for these two types of credit business to be kept distinctly apart; funds are drawn for each of them from different sources and disposed of through different forms of securities.

The problem of agriculture is of a quite different order. There is widespread agreement that in almost all the

underdeveloped territories of the world the supply of credit to agriculture is inefficient and inadequate.[14] In particular, the expatriate banks have almost universally stood aloof from agricultural finance (other than the provision of working capital for the expatriate enterprises producing for export) largely because of the difficulties presented by communications, the lack of conventional forms of security—especially mortgages—and the small-scale nature of most of the indigenous agriculture of these countries. The need to provide adequate credit to agriculture is certainly of the highest priority in all of them. Nevertheless, it would not appear wise for the provision of this type of credit to be combined with the provision of credit to the general field of manufacturing industry.

The main reason for this is that in almost every country of the world the support of agriculture is by way of being a political, as well as an economic, matter. It is almost invariably found expedient to provide farmers, especially the small-scale farmers typical of these countries, with credit at abnormally low rates of interest, on terms which are distinctly generous so far as maturity and redemption conditions are concerned, and against a type of security which would probably not meet ordinary commercial standards. Further, extension services of all kinds are almost invariably equally essential as the provision of credit; these need to go much further than the type of advice and consultancy mentioned earlier in connection with industrial investment. Reflecting on the experience of agricultural credit in India one commentator observes that

> Cheap and easy credit has often enough been the ruin of the thirftless individual farmer, who has used this double-edged sword to his own undoing. What he requires is cheap, but controlled credit....[15]

The institution involved in agriculture finance must thus also be concerned with a range of services well outside the strictly

[14]See Sen, op. cit., Ch. 10, pp. 210–11, Ali, op. cit., p. 60, and E. Laso, op. cit., p. 433. One investigator has concluded that agriculture accounts for less than 10 per cent of total commercial bank lending in most underdeveloped territories—U Tun Wai, 'Interest rates outside the organised money markets of underdeveloped countries', *I.M.F. Staff Papers*, Vol. VI, No. 1, November 1957, p. 94.

[15]*Domestic Financing of Economic Development*, p. 133.

financial sphere, usually taking the form of the provision of equipment, seeds, marketing facilities etc., all at something well below their true cost.[16] Experience provides overwhelming proof that such supervision and control of agricultural credit is essential even on grounds of common financial prudence, and it is unfortunate that they are in fact substantially absent in most underdeveloped countries.[17] In addition to this, the assistance of the small-scale farmer is a matter of political and social importance, quite apart from its economic significance. In the words of a United Nations report,

> . . . the abolition of the small farmer was neither feasible nor desirable. The issue was therefore both an economic and a social one, and the credit problems involved could not be solved as an independent technical problem outside the general framework of social and economic policy. . . . Part of the assistance might be given with the idea of eventual repayment and part of it without hoping to be reimbursed, more as a relief measure than as an extension of credit. . . .[18]

As a result of all this, any institution involved in the provision of credit to agriculture almost inevitably needs to be subsidised in some way or another. Whatever the economic rights and wrongs of the question, agricultural credit is in reality a subsidised service in most parts of the world, and will probably continue to be so for as long as can be foreseen. It would therefore be extremely difficult for a development institution to utilise funds on an economic basis and simultaneously associate itself with a type of lending which is universally known to be uneconomic in any real sense of the word. It is important that the finance institution should be seen to be operated on reasonably sound, economic lines if it is to hope to attract capital from private investors both within and beyond its borders.[19] It is

[16]All this, as Diamond remarks 'makes the problem of farm credit quite different in kind from that of industrial credit'—op. cit., p. 16; see also p. 48. Agricultural credit in such countries, remarks another writer, is not only a technical and banking problem but also a social one—Ali, op. cit., p. 67.

[17]U Tun Wai, ibid., p. 93.

[18]*Domestic Financing of Economic Development*, p. 84.

[19]Diamond, op. cit., p. 81.

impossible for it to do this if part of its investment activity takes the form of credit which cannot be justified on the ordinary economic standards which would be applicable to industrial investment, even standards resting on the sort of basis referred to above—namely, one taking a distinctly long-run view and measuring profit-outcomes in a distinctly broad sense.

In would appear to be best, therefore, for agricultural credit to be administered by a separate institution which could itself be closely integrated with the various other agencies of agricultural policy in the country. This would have the disadvantage that a part of the credit flow would be administered separately from the remainder, so that there would be no guarantee that the proper allocation of scarce capital between individual industrial and agricultural projects would be secured at the margin. Nevertheless, the danger of confusing industrial investment with subsidised agricultural credit is so great that this penalty seems to be well worth paying.[20]

THE FINANCE OF SMALL BUSINESS

Another sector to which comparable considerations apply is that of small-scale business, meaning by this enterprises which are at an early stage of development and which involve probably only a single proprietor and a small number of employees. This is a type of enterprise which also involves political issues as well as economic considerations. The protection and encouragement of small-scale enterprise is usually regarded as being a matter of social importance, and is a policy aim which most governments regard as being outside the bounds of a strictly economic calculus. Because of the administrative expense and high default-probability involved, it is an almost universal experience that institutions involved in the lending of funds to small-scale business find themselves doing so at a loss. There is a point below which the size of loan simply cannot be economically carried; beyond this the costs of servicing and collecting interest and capital repayments are so high, and the incidence of default so great, that the

[20]For a survey of the agricultural credit problems see H. Belshaw, *Agricultural Credit in Economically Underdeveloped Countries*, F.A.O. Agricultural Study No. 46, Columbia University Press, New York 1960, and Hanson, op. cit., Ch. IX, pp. 258–78.

provision of such credit becomes quite unprofitable.[21] Any institution concerned with the finance of small-scale business can therefore scarcely hope to conduct its business on economic lines. The parallel with agricultural credit is thus almost exact; a development finance institution seeking to hold out to investors the promise of the use of funds on reasonably economic lines, and of being profitable at least in the long run, cannot hope to achieve this end if it is involved with the provision of credit to small business. Such business is simply incompatible with the operation of an institution on a break-even basis, let alone a profitable one.

Despite the disadvantages of separating one element of the flow of credit from 'social' investment finance over the economy as a whole, therefore, practical considerations again suggest that separate arrangements be made to meet this particular need. If this is not possible—and it might certainly involve a duplication and wastage of administrative resources—then it is essential that the finance institution should conduct its lending to small businesses as an entirely separate and distinct part of its total activity, using separate funds and drawing up a separate balance sheet for it.[22] The element of subsidy in this part of its business could then be seen clearly and responsibility for it could be passed to the government, where it belongs. In this way the institution could assure the investor that this particular part of its activities—if it ran counter to ordinary economic considerations—was entirely separate, and was not financed with

[21]Hence the astonishing estimate that the Reconstruction Finance Corporation in the United States lost nearly $6000 on each loan of $1000 it made, and the agonised remark of one of its directors that 'There is no way for a corporation which operates with our checks and balances to make a $1500 GI loan and make any money on it. I am sure we would be better off if we wrote them a check and called it a day'. (Saulnier, Halcrow and Jacoby, *Federal Lending and Loan Insurance*, National Bureau of Economic Research, Princeton University Press, Princeton 1958, Appx. B, pp. 512-13). Similarly, the Industrial and Commercial Finance Corporation in the United Kingdom has found that loans of less than $15,000 show no profit and are probably losing propositions if full account is taken of investigation and administration costs—Diamond, op. cit., pp. 48-49.

[22]The United Nations report *Domestic Financing of Economic Development* (p. 58) stresses the aggravation of the scarcity of qualified personnel which follows from a multiplicity of credit institutions; it therefore pronounces in favour of subsidy or direct assistance for small businesses.

funds collected from private sources to which strictly economic principles were applied. The funds used in loans to small businesses would be only those especially set aside for the purpose by the government; similarly, the assets acquired against them would be separated off and any losses on them distinguished in the operating account of its main business.[23] This would at least eliminate the fear—ever present in the mind of the private investor in a situation such as this—that an institution set up to collect and invest savings would be forced into uneconomic and unprofitable lines of business in the interests of political pressure-groups and official government policy.[24]

[23]This type of procedure has been adopted in Mexico and Puerto Rico; in countries such as India and Pakistan, on the other hand, lending to small concerns has been hived off to separate institutions—see Boskey, op. cit., pp. 58-61.

[24]More or less identical arguments as those presented in this and the preceding section apply to the provision of finance for housing, another field in which social considerations and subsidies appear to be universally applied. The construction of low-cost housing is often administered directly by a government department, however, and development finance institutions are seldom saddled with this responsibility.

18

The State of Long-Term Expectation*

John Maynard Keynes

In this passage Keynes provides us with a penetrating insight into the operation of security markets. As he shows, professional speculation, because of its emphasis on liquidity and short-run expectations, fails to guide the flow of investment in accordance with long-term profitability. For this very reason, such speculation is a source of instability. Keynes seems, on the whole, to be disappointed with the spectacle of mordern investment markets.

Editor

I

The scale of investment depends on the relation between the rate of interest and the schedule of the marginal efficiency of capital corresponding to different scales of current investment, whilst the marginal efficiency of capital depends on the relation between the supply price of a capital-asset and its prospective yield. In this chapter we shall consider some of the factors which determine the prospective yield of an asset.

The considerations upon which expectations of prospective

*Taken from John Maynard Keynes, *The General Theory of Employment, Interest and Money*, Macmillan and Co., Limited, London, 1936, pp. 147-64. Reprinted by permission of Macmillan London and Basingstoke.

yields are based are partly existing facts which we can assume to be known more or less for certain, and partly future events which can only be forecasted with more or less confidence. Amongst the first may be mentioned the existing stock of various types of capital-assets and of capital-assets in general and the strength of the existing consumers' demand for goods which require for their efficient production a relatively larger assistance from capital. Amongst the latter are future changes in the type and quantity of the stock of capital-assets and in the tastes of the consumer, the strength of effective demand from time to time during the life of the investment under consideration, and the changes in the wage-unit in terms of money which may occur during its life. We may sum up the state of psychological expectation which covers the latter as being the *state of long-term expectation*;—as distinguished from the short-term expectation upon the basis of which a producer estimates what he will get for a product when it is finished if he decides to begin producing it to-day with the existing plant.

II

It would be foolish, in forming our expectations, to attach great weight to matters which are very uncertain.[1] It is reasonable, therefore, to be guided to a considerable degree by the facts about which we feel somewhat confident, even though they may be less decisively relevant to the issue than other facts about which our knowledge is vague and scanty. For this reason the facts of the existing situation enter, in a sense disproportionately, into the formation of our long-term expectations; our usual practice being to take the existing situation and to project it into the future, modified only to the extent that we have more or less definite reasons for expecting a change.

The state of long-term expectation, upon which our decisions are based, does not solely depend, therefore, on the most probable forecast we can make. It also depends on the *confidence* with which we make this forecast—on how highly we

[1] By 'very uncertain' I do not mean the same thing as 'very improbable'. Cf. my *Treatise on Probability*, Ch. 6, on 'The Weight of Arguments'.

rate the likelihood of our best forecast turning out quite wrong. If we expect large changes but are very uncertain as to what precise form these changes will take, then our confidence will be weak.

The state of confidence, as they term it, is a matter to which practical men always pay the closest and most anxious attention. But economists have not analysed it carefully and have been content, as a rule, to discuss it in general terms. In particular it has not been made clear that its relevance to economic problems comes in through its important influence on the schedule of the marginal efficiency of capital. There are not two separate factors affecting the rate of investment, namely, the schedule of the marginal efficiency of capital and the state of confidence. The state of confidence is relevant because it is one of the major factors determining the former, which is the same thing as the investment demand-schedule.

There is, however, not much to be said about the state of confidence *a priori*. Our conclusions must mainly depend upon the actual observation of markets and business psychology. This is the reason why the ensuing digression is on a different level of abstraction from most of this book.

For convenience of exposition we shall assume in the following discussion of the state of confidence that there are no changes in the rate of interest; and we shall write, throughout the following sections, as if changes in the values of investments were solely due to changes in the expectation of their prospective yields and not at all to changes in the rate of interest at which these prospective yields are capitalised. The effect of changes in the rate of interest is, however, easily superimposed on the effect of changes in the state of confidence.

III

The outstanding fact is the extreme precariousness of the basis of knowledge on which our estimates of prospective yield have to be made. Our knowledge of the factors which will govern the yield of an investment some years hence is usually very slight and often negligible. If we speak frankly, we have to admit that our basis of knowledge for estimating the yield ten years hence of a railway, a copper mine, a textile factory,

the goodwill of a patent medicine, an Atlantic liner, a building in the City of London amounts to little and sometimes to nothing; or even five years hence. In fact, those who seriously attempt to make any such estimate are often so much in the minority that their behaviour does not govern the market.

In former times, when enterprises were mainly owned by those who undertook them or by their friends and associates, investment depended on a sufficient supply of individuals of sanguine temperament and constructive impulses who embarked on business as a way of life, not really relying on a precise calculation of prospective profit. The affair was partly a lottery, though with the ultimate result largely governed by whether the abilities and character of the managers were above or below the average. Some would fail and some would succeed. But even after the event no one would know whether the average results in terms of the sums invested had exceeded, equalled or fallen short of the prevailing rate of interest; though, if we exclude the exploitation of natural resources and monopolies, it is probable that the actual average results of investments, even during periods of progress and prosperity, have disappointed the hopes which prompted them. Businessmen play a mixed game of skill and chance, the average results of which to the players are not known by those who take a hand. If human nature felt no temptation to take a chance, no satisfaction (profit apart) in constructing a factory, a railway, a mine or a firm, there might not be much investment merely as a result of cold calculation.

Decisions to invest in private business of the old-fashioned type were, however, decisions largely irrevocable, not only for the community as a whole, but also for the individual. With the separation between ownership and management which prevails to-day and with the development of organised investment markets, a new factor of great importance has entered in, which sometimes facilitates investment but sometimes adds greatly to the instability of the system. In the absence of security markets, there is no object in frequently attempting to revalue an investment to which we are committed. But the Stock Exchange revalues many investments every day and the revaluations give a frequent opportunity to the individual (though not to the community as a whole) to revise his commitments. It is as though a farmer, having tapped his barometer after breakfast,

could decide to remove his capital from the farming business between 10 and 11 in the morning and reconsider whether he should return to it later in the week. But the daily revaluations of the Stock Exchange, though they are primarily made to facilitate transfers of old investments between one individual and another, inevitably exert a decisive influence on the rate of current investment. For there is no sense in building up a new enterprise at a cost greater than that at which a similar existing enterprise can be purchased; whilst there is an inducement to spend on a new project what may seem an extravagant sum, if it can be floated off on the Stock Exchange at an immediate profit.[2] Thus certain classes of investment are governed by the average expectation of those who deal on the Stock Exchange as revealed in the price of shares, rather than by the genuine expectations of the professional entrepreneur.[3] How then are these highly significant daily, even hourly, revaluations of existing investments carried out in practice?

IV

In practice we have tacitly agreed, as a rule, to fall back on what is, in truth, a *convention.* The essence of this convention —though it does not, of course, work out quite so simply—lies in assuming that the existing state of affairs will continue indefinitely, except in so far as we have specific reasons to expect a change. This does not mean that we really believe that the existing state of affairs will continue indefinitely. We

[2]In my *Treatise on Money* (vol. ii, p. 195) I pointed out that when a company's shares are quoted very high so that it can raise more capital by issuing more shares on favourable terms, this has the same effect as if it could borrow at a low rate of interest. I should now describe this by saying that a high quotation for existing equities involves an increase in the marginal efficiency of the corresponding type of capital and therefore has the same effect (since investment depends on a comparison between the marginal efficiency of capital and the rate of interest) as a fall in the rate of interest.

[3]This does not apply, of course, to classes of enterprise which are not readily marketable or to which no negotiable instrument closely corresponds. The categories falling within this exception were formerly extensive. But measured as a proportion of the total value of new investment they are rapidly declining in importance.

know from extensive experience that this is most unlikely. The actual results of an investment over a long term of years very seldom agree with the initial expectation. Nor can we rationalise our behaviour by arguing that to a man in a state of ignorance errors in either direction are equally probable, so that there remains a mean actuarial expectation based on equiprobabilities. For it can easily be shown that the assumption of arithmetically equal probabilities based on a state of ignorance leads to absurdities. We are assuming, in effect, that the existing market valuation, however arrived at, is uniquely *correct* in relation to our existing knowledge of the facts which will influence the yield of the investment, and that it will only change in proportion to changes in this knowledge; though, philosophically speaking, it cannot be uniquely correct, since our existing knowledge does not provide a sufficient basis for a calculated mathematical expectation. In point of fact, all sorts of considerations enter into the market valuation which are in no way relevant to the prospective yield.

Nevertheless the above conventional method of calculation will be compatible with a considerable measure of continuity and stability in our affairs, *so long as we can rely on the maintenance of the convention.*

For if there exist organised investment markets and if we can rely on the maintenance of the convention, an investor can legitimately encourage himself with the idea that the only risk he runs is that of a genuine change in the news *over the near future*, as to the likelihood of which he can attempt to form his own judgment, and which is unlikely to be very large. For, assuming that the convention holds good, it is only these changes which can affect the value of his investment, and he need not lose his sleep merely because he has not any notion what his investment will be worth ten years hence. Thus investment becomes reasonably 'safe' for the individual investor over short periods, and hence over a succession of short periods however many, if he can fairly rely on there being no breakdown in the convention and on his therefore having an opportunity to revise his judgment and change his investment, before there has been time for much to happen. Investments which are 'fixed' for the community are thus made 'liquid' for the individual.

It has been, I am sure, on the basis of some such procedure

as this that our leading investment markets have been developed. But it is not surprising that a convention, in an absolute view of things so arbitrary, should have its weak points. It is its precariousness which creates no small part of our contemporary problem of securing sufficient investment.

V

Some of the factors which accentuate this precariousness may be briefly mentioned.

(1) As a result of the gradual increase in the proportion of the equity in the community's aggregate capital investment which is owned by persons who do not manage and have no special knowledge of the circumstances, either actual or prospective, of the business in question, the element of real knowledge in the valuation of investments by those who own them or contemplate purchasing them has seriously declined.

(2) Day-to-day fluctuations in the profits of existing investments. which are obviously of an ephemeral and non-significant character, tend to have an altogether excessive, and even an absurd, influence on the market. It is said, for example, that the shares of American companies which manufacture ice tend to sell at a higher price in summer when their profits are seasonally high than in winter when no one wants ice. The recurrence of a bank-holiday may raise the market valuation of the British railway system by several million pounds.

(3) A conventional valuation which is established as the outcome of the mass psychology of a large number of ignorant individuals is liable to change violently as the result of a sudden fluctuation of opinion due to factors which do not really make much difference to the prospective yield; since there will be no strong roots of conviction to hold it steady. In abnormal times in particular, when the hypothesis of an indefinite continuance of the existing state of affairs is less plausible than usual even though there are no express grounds to anticipate a definite change, the market will be subject to waves of optimistic and pessimistic sentiment, which are unreasoning and yet in a sense legitimate where no solid basis exists for a reasonable calculation.

(4) But there is one feature in particular which deserves

our attention. It might have been supposed that competition between expert professionals, possessing judgment and knowledge beyond that of the average private investor, would correct the vagaries of the ignorant individual left to himself. It happens, however, that the energies and skill of the professional investor and speculator are mainly occupied otherwise For most of these persons are, in fact, largely concerned, not with making superior long-term forecasts of the probable yield of an investment over its whole life, but with foreseeing changes in the conventional basis of valuation a short time ahead of the general public. They are concerned, not with what an investment is really worth to a man who buys it 'for keeps', but with what the market will value it at, under the influence of mass psychology, three months or a year hence. Moreover, this behaviour is not the outcome of a wrong-headed propensity. It is an inevitable result of an investment market organised along the lines described. For it is not sensible to pay 25 for an investment of which you believe the prospective yield to justify a value of 30, if you also believe that the market will value it at 20 three months hence.

Thus the professional investor is forced to concern himself with the anticipation of impending changes in the news or in the atmosphere, of the kind by which experience shows that the mass psychology of the market is most influenced. This is the inevitable result of investment markets organised with a view to so-called 'liquidity'. Of the maxims of orthodox finance none, surely, is more anti-social than the fetish of liquidity, the doctrine that it is a positive virtue on the part of investment institutions to concentrate their resources upon the holding of 'liquid' securities. It forgets that there is no such thing as liquidity of investment for the community as a whole. The social object of skilled investment should be to defeat the dark forces of time and ignorance which envelop our future. The actual, private object of the most skilled investment to-day is 'to beat the gun', as the Americans so well express it, to outwit the crowd, and to pass the bad, or depreciating, half-crown to the other fellow.

This battle of wits to anticipate the basis of conventional valuation a few months hence, rather than the prospective yield of an investment over a long term of years, does not

even require gulls amongst the public to feed the maws of the professional;—it can be played by professionals amongst themselves. Nor is it necessary that anyone should keep his simple faith in the conventional basis of valuation having any genuine long-term validity.

For it is, so to speak, a game of Snap, of Old Maid, of Musical Chairs—a pastime in which he is victor who says *Snap* neither too soon nor too late, who passes the Old Maid to his neighbour before the game is over, who secures a chair for himself when the music stops. These games can be played with zest and enjoyment though all the players know that it is the Old Maid which is circulating, or that when the music stops some of the players will find themselves unseated.

Or, to change the metaphor slightly, professional investment may be likened to those newspaper competitions in which the competitors have to pick out the six prettiest faces from a hundred photographs, the prize being awarded to the competitor whose choice most nearly corresponds to the average preferences of the competitors as a whole; so that each competitor has to pick, not those faces which he himself finds prettiest, but those which he thinks likeliest to catch the fancy of the other competitors, all of whom are looking at the problem from the same point of view. It is not a case of choosing those which, to the best of one's judgment, are really the prettiest, nor even those which average opinion genuinely thinks the prettiest. We have reached the third degree where we devote our intelligences to anticipating what average opinion expects the average opinion to be. And there are some, I believe, who practise the fourth, fifth and higher degrees.

If the reader interjects that there must surely be large profits to be gained from the other players in the long run by a skilled individual who, unperturbed by the prevailing pastime, continues to purchase investments on the best genuine long-term expectations he can frame, he must be answered, first of all, that there are, indeed, such serious-minded individuals and that it makes a vast difference to an investment market whether or not they predominate in their influence over the game-players. But we must also add that there are several factors which jeopardise the predominance of such individuals in modern investment markets. Investment based on genuine long-term

expectation is so difficult to-day as to be scarcely practicable. He who attempts it must surely lead much more laborious days and run greater risks than he who tries to guess better than the crowd how the crowd will behave; and, given equal intelligence, he may make more disastrous mistakes. There is no clear evidence from experience that the investment policy which is socially advantageous coincides with that which is most profitable. It needs *more* intelligence to defeat the forces of time and our ignorance of the future than to beat the gun. Moreover life is not long enough;—human nature desires quick results, there is a peculiar zest in making money quickly, and remoter gains are discounted by the average man at a very high rate. The game of professional investment is intolerably boring and over-exacting to anyone who is entirely exempt from the gambling instinct; whilst he who has it must pay to this propensity the appropriate toll. Furthermore, an investor who proposes to ignore near-term market fluctuations needs greater resources for safety and must not operate on so large a scale, if at all, with borrowed money—a further reason for the higher return from the pastime to a given stock of intelligence and resources. Finally it is the long-term investor, he who most promotes the public interest, who will in practice come in for most criticism, wherever investment funds are managed by committees or boards or banks.[4] For it is in the essence of his behaviour that he should be eccentric, unconventional and rash in the eyes of average opinion. If he is successful, that will only confirm the general belief in his rashness; and if in the short run he is unsuccessful, which is very likely, he will not receive much mercy. Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally.

(5) So far we have had chiefly in mind the state of confidence of the speculator or speculative investor himself and may have seemed to be tacitly assuming that, if he himself is satisfied with the prospects, he has unlimited command over money at the market rate of interest. This is, of course, not the

[4] The practice, usually considered prudent, by which an investment trust or an insurance office frequently calculates not only the income from its investment portfolio but also its capital valuation in the market, may also tend to direct too much attention to short-term fluctuations in the latter.

case. Thus we must also take account of the other facet of the state of confidence, namely, the confidence of the lending institutions towards those who seek to borrow from them, sometime described as the state of credit. A collapse in the price of equities, which has had disastrous reactions on the marginal efficiency of capital, may have been due to the weakening of either of speculative confidence or of the state of credit. But whereas the weakening of either is enough to cause a collapse, recovery requires the revival of *both*. For whilst the weakening of credit is sufficient to bring about a collapse, its strengthening, though a necessary condition of recovery, is not a sufficient condition.

VI

These considerations should not lie beyond the purview of the economist. But they must be relegated to their right perspective. If I may be allowed to appropriate the term *speculation* for the activity of the forecasting the psychology of the market, and the term *enterprise* for the activity of forecasting the prospective yield of assets over their whole life, it is by no means always the case that speculation predominates over enterprise. As the organisation of investment markets improves, the risk of the predominance of speculation does, however, increase. In one of the greatest investment markets in the world, namely, New York, the influence of speculation (in the above sense) is enormous. Even outside the field of finance, Americans, are apt to be unduly interested in discovering what average opinion believes average opinion to be; and this national weakness finds its nemesis in the stock market. It is rare, one is told, for an American to invest, as many Englishmen still do, 'for income'; and he will not readily purchase an investment except in the hope of capital appreciation. This is only another way of saying that, when he purchases an investment, the American is attaching his hopes, not so much to its prospective yield, as to a favourable change in the conventional basis of valuation, i.e., that he is, in the above sense, a speculator. Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation. When the capital development of a country becomes a by-product of the

activities of a casino, the job is likely to be ill-done. The measure of success attained by Wall Street, regarded as an institution of which the proper social purpose is to direct new investment into the most profitable channels in terms of future yield, cannot be claimed as one of the outstanding triumphs of *laissez-faire* capitalism—which is not surprising, if I am right in thinking that the best brains of Wall Street have been in fact directed towards a different object.

These tendencies are a scarcely avoidable outcome of our having successfully organised 'liquid' investment markets. It is usually agreed that casinos should, in the public interest, be inaccessible and expensive. And perhaps the same is true of Stock Exchanges. That the sins of the London Stock Exchange are less than those of Wall Street may be due, not so much to differences in national character, as to the fact that to the average Englishman Throgmorton Street is, compared with Wall Street to the average American, inaccessible and very expensive. The jobber's 'turn', the high brokerage charges and the heavy transfer tax payable to the Exchequer, which attend dealings on the London Stock Exchange, sufficiently diminish the liquidity of the market (although the practice of fortnightly accounts operates the other way) to rule out a large proportion of the transactions characteristic of Wall Street.[5] The introduction of a substantial Government transfer tax on all transactions might prove the most serviceable reform available, with a view to mitigating the predominance of speculation over enterprise in the United States.

The spectacle of modern investment markets has sometimes moved me towards the conclusion that to make the purchase of an investment permanent and indissoluble, like marriage, except by reason of death or other grave cause, might be a useful remedy for our contemporary evils. For this would force the investor to direct his mind to the long-term prospects and to those only. But a little consideration of this expedient brings us up against a dilemma, and shows us how the liquidity of investment markets often facilitates, though it sometimes

[5] It is said that, when Wall Street is active, at least a half of the purchases or sales of investments are entered upon with an intention on the part of the speculator to reverse them *the same day*. This is often true of the commodity exchanges also.

impedes, the course of new investment. For the fact that each individual investor flatters himself that his commitment is 'liquid' (though this cannot be true for all investors collectively) calms his nerves and makes him much more willing to run a risk. If individual purchases of investments were rendered illiquid, this might seriously impede new investment, so long as *alternative ways* in which to hold his savings are available to the individual. This is the dilemma. So long as it is open to the individual to employ his wealth in hoarding or lending *money*, the alternative of purchasing actual capital assets cannot be rendered sufficiently attractive (especially to the man who does not manage the capital assets and knows very little about them), except by organising markets wherein these assets can be easily realised for money.

The only radical cure for the crises of confidence which afflict the economic life of the modern world would be to allow the individual no choice between consuming his income and ordering the production of the specific capital-asset which, even though it be on precarious evidence, impresses him as the most promising investment available to him. It might be that, at times when he was more than usually assailed by doubts concerning the future, he would turn in his perplexity towards more consumption and less new investment. But that would avoid the disastrous, cumulative and far-reaching repercussions of its being open to him, when thus assailed by doubts, to spend his income neither on the one nor on the other.

Those who have emphasised the social dangers of the hoarding of money have, of course, had something similar to the above in mind. But they have overlooked the possibility that the phenomenon can occur without any change, or at least any commensurate change, in the hoarding of money.

VII

Even apart from the instability due to speculation, there is the instability due to the characteristic of human nature that a large proportion of our positive activities depend on spontaneous optimism rather than on a mathematical expectation, whether moral or hedonistic or economic. Most, probably, of our decisions to do something positive, the full consequences of

which will be drawn out over many days to come, can only be taken as a result of animal spirits—of a spontaneous urge to action rather than inaction, and not as the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities. Enterprise only pretends to itself to be mainly actuated by the statements in its own prospects, however candid and sincere. Only a little more than an expedition to the South Pole, is it based on an exact calculation of benefits to come. Thus if the animal spirits are dimmed and the spontaneous optimism falters, leaving us to depend on nothing but a mathematical expectation, enterprise will fade and die;—though fears of loss may have a basis no more reasonable than hopes of profit had before.

It is safe to say that enterprise which depends on hopes stretching into the future benefits the community as a whole. But individual initiative will only be adequate when reasonable calculation is supplemented and supported by animal spirits, so that the thought of ultimate loss which often overtakes pioneers, as experience undoubtedly tells us and them, is put aside as a healthy man puts aside the expectation of death.

This means, unfortunately, not only that slumps and depressions are exaggerated in degree, but that economic prosperity is excessively dependent on a political and social atmosphere which is congenial to the average businessman. If the fear of a Labour Government or a New Deal depresses enterprise, this need not be the result either of a reasonable calculation or of a plot with political intent;—it is the mere consequence of upsetting the delicate balance of spontaneous optimism. In estimating the prospects of investment, we must have regard, therefore, to the nerves and hysteria and even the digestions and the reactions to the weather of those upon whose spontaneous activity it largely depends.

We should not conclude from this that everything depends on waves of irrational psychology. On the contrary, the state of long-term expectation is often steady, and, even when it is not, the other factors exert their compensating effects. We are merely reminding ourselves that human decisions affecting the future, whether personal or political or economic, cannot depend on strict mathematical expectation, since the basis for making such calculations does not exist; and that it is our innate urge

to activity which makes the wheels go round, our rational selves choosing between the alternatives as best we are able, calculating where we can, but often falling back for our motive on whim or sentiment or chance.

VIII

There are, moreover, certain important factors which somewhat mitigate in practice the effects of our ignorance of the future. Owing to the operation of compound interest combined with the likelihood of obsolescence with the passage of time, there are many individual investments of which the prospective yield is legitimately dominated by the returns of the comparatively near future. In the case of the most important class of very long-term investments, namely buildings, the risk can be frequently transferred from the investor to the occupier, or at least shared between them, by means of long-term contracts, the risk being outweighed in the mind of the occupier by the advantages of continuity and security of tenure. In the case of another important class of long-term investments, namely public utilities, a substantial proportion of the prospective yield is practically guaranteed by monopoly privileges coupled with the right to charge such rates as will provide a certain stipulated margin. Finally there is a growing class of investments entered upon by, or at the risk of, public authorities, which are frankly influenced in making the investment by a general presumption of there being prospective social advantages from the investment, whatever its commercial yield may prove to be within a wide range, and without seeking to be satisfied that the mathematical expectation of the yield is at least equal to the current rate of interest,—though the rate which the public authority has to pay may still play a decisive part in determining the scale of investment operations which it can afford.

Thus after giving full weight to the importance of the influence of short-period changes in the state of long-term expectation as distinct from changes in the rate of interest, we are still entitled to return to the latter as exercising, at any rate, in normal circumstances, a great, though not a decisive, influence on the rate of investment. Only experience, however, can show how far management of the rate of interest is capable of

continuously stimulating the appropriate volume of investment.

For my own part I am now somewhat sceptical of the success of a merely monetary policy directed towards influencing the rate of interest. I expect to see the State, which is in a position to calculate the marginal efficiency of capital-goods on long views and on the basis of the general social advantage, taking an ever greater responsibility for directly organising investment; since it seems likely that the fluctuations in the market estimation of the marginal efficiency of different types of capital, calculated on the principles I have described above, will be too great to be offset by any practicable changes in the rate of interest.

19

Trading Markets—Introduction*

This extract describes the structure, functioning and types of trading markets in securities. It also critically discusses the tests of efficiency which such markets should satisfy.

Editor

BASIC COMPONENTS OF TRADING MARKETS

The broad term 'securities markets' encompasses both the markets for distribution of securities into public hands and the markets for continuous trading in outstanding securities.[1] It will be seen that the uses and mechanisms of trading markets are substantially different from those of distribution markets, although there is an overlapping area having imprecise boundaries but consisting of distribution into wider public ownership of blocks of securities already outstanding (secondary distributions), and the handling of large blocks in the trading markets.

The present chapter contains general introductory material including brief discussions of basic components, concepts, and standards applicable to trading markets and basic differences and similarities between types of markets.

*Taken from U. S. Securities and Exchange Commission, *Report of Special Study of Securities Markets*, Part 2, U. S. Government Printing Office, Washington, 1963, pp. 5–20.

[1]In general, this report does not consider the category of Government obligations, and devotes relatively little attention to corporate bonds as a separate category.

PARTICIPANTS IN TRADING MARKETS—'PROFESSIONAL' AND 'PUBLIC'

Participants in the trading markets include both 'professionals' and the 'public'. The professionals—those who make their livelihood in the securities business as underwriters, brokers, or dealers—have widely varying characteristics and activities. At one extreme, the professionals may be members of giant wirehouses with memberships on several exchanges and with nationwide or even worldwide networks of branches and correspondents; at the other. they may be one-man firms trading only in over-the-counter markets. The public—all who invest or trade in securities but are not in the securities business in the above sense—again show a tremendous range, from the very small or new investor who may lack market experience and sophistication and may depend for investment advice upon salesmen of varying degrees of skills and knowledge, to the great pension funds, investment companies, insurance companies, banks, and eleemosynary institutions and foundations, which may have large staffs of financial analysis at their disposal.

The public's access to trading markets is through the professionals—'brokers' who act as agents for the public in buying or selling, and 'dealers' who sell to or buy from their customers for their own account as principals. A firm or individual in the securities business is permitted to combine the functions of broker and dealer and from time to time may act in one capacity or the other depending on the circumstances. Whatever the amount or kind of his transactions with the public, a broker-dealer may also buy or sell for his own account as an investor or trader. Most of these transactions presumably are entered into with the same kinds of motivation as any other investor's, i.e., to obtain a return on capital, capital appreciation, and/or trading profits. In the case of some professionals, however, particularly the specialists and odd-lot dealers on stock exchanges and 'market makers' in over-the-counter markets, certain of their transactions are induced by needs of the market itself. In his transactions for his own account, the professional usually enjoys the advantages, among others, of immediate and intimate contact with the market, of trading in the 'inside' market and/or paying lower commissions.

In the nonprofessional sector, two important developments

in recent years have been a considerable increase in the number of persons owning securities, and substantial growth in activity on the part of institutions.[2] Thus, during the 1952–61 decade, the number of individual share owners in America grew almost three times. Despite this expansion, activity of individuals as a prcportion of total share volume on the New York Stock Exchange, according to its public transaction surveys, shrank from 57 per cent for 2 test days in 1952 to 51.4 per cent on the test day in 1961, while activity of institutions (which were growing substantially in number and size) during the same period rose from 24.6 per cent on the test days in 1952 and 19.3 on the test days in 1953 to 26.2 per cent of share volume on the test day in 1961.[3] With respect to particular securities, however, the degree of public participation may differ widely, so that the markets in certain issues may be dominated by institutional trading while in other cases, by individuals' or members' transactions. For example, on September 31, 1961, when institutions accounted for 26.2 per cent of total New York Stock Exchange trading, they accounted for 90 per cent of the purchases of Internationl Nickel of Canada and 5 per cent of the sales, while individuals accounted for 1.5 per cent of the purchases and 4 per cent of sales.[4] (Though

[2]On institutions' impact on the stock market, see staff of Senate Committee on Banking and Currency, 84th Cong., 2nd sess., 'Report on Institutional Investors and the Stock Market, 1953–55', pp. 25–35 (committee print, 1956) ; and the report prepared for the SEC by the Wharton School of Finance and Commerce. 'A Study of Mutual Funds', H. Rept. 2274. 87th Cong., 2nd sess., pp. 21–24, 262–282, 359–397 (1962).

[3]NYSE, '1961 Public Transaction Study', pp. 2–3. In calculating total volume, the Exchange made adjustments for nonreported volume and for public transactions which were not accounted for by members.

As pointed out in subsequent chapters, there is strong reason to believe that, if dollar volumes were considered, the percentages would be significantly higher for institutions and significantly lower for the general public than the above figures. However, this would not affect the trends described in the text.

[4]The analysis of the trading in individual stocks was made by the Special Study, based on data from the NYSE and the odd-lot dealers. Data were not available to adjust reported volume figures for individual stocks as the NYSE had adjusted total volume figures. Therefore, the percentages for individual stocks are not strictly comparable to the percentages of total volume, but any distortion is likely to be small, because of the nature of the adjustments made by the NYSE.

figures are unavailable, members presumably accounted for the remainder of the trading.) On the other hand, on that day individuals dominated trading in Studebaker-Packard by purchasing 68 per cent and selling 63 per cent, while institutions purchased 4 per cent and sold 5 per cent.

THE TWO BASIC TYPES OF TRADING MARKETS IN THE UNITED STATES

The governing Federal law recognizes two basic types of trading markets—'exchanges' and 'over-the-counter,' respectively. For regulatory purposes all the registered exchanges[5] are treated as a single category, but the Commission is empowered to exempt such an exchange from certain rules otherwise generally applicable and to make rules for only one or several of these exchanges,[6] and each exchange is permitted to have and does have its own set of rules and regulations. Over-the-counter markets also are treated as a single category for regulatory purposes. However, by definition they are an essentially residual category : all trading that does not occur on an exchange is characterized as over-the-counter, and all broker-dealers registered with the Commission are entitled to participate.[7] As is developed below, there is great heterogeneity in the securities traded, and the precise character of the over-the-counter market for each security tends to adjust itself to the characteristics of that security.

[5]There are 14 registered exchanges and 4 exempt.

[6]Exchange Act, secs. 11 (c) and 19 (b).

There has been no occasion for formal exemption under the former section, since the Commission has never formally exercised its rule-making power under that section; the exchanges, acting independently and at the suggestion of the Commission, have made rules on the matters covered by sec. 11.

The Commission has brought formal proceedings under the latter section only once. In the matter of NYSE rules limiting transactions by members in NYSE-listed securities also traded on other exchanges. *In the Matter of The Rules of The New York Stock Exchange*, 10 S.E.C. 270 (1941). This decision is discussed in ch. VIII. E.

[7]See sec. 15 (a) of the Exchange Act for those broker-dealers who are not required to register in order to participate in certain limited areas of the over-the-counter market.

Contrasting Aspects of the Two Types

Exchange markets and over-the-counter trading markets are fundamentally similar in purpose and functions but substantially dissimilar in mechanics and practices. A brief introductory enumeration of certain of their respective characteristics may help to show their basic similarities and differences and, as to the latter, may help to differentiate between those that are fundamental, inherent or substructural, and those that are merely historical, superficial or incidental. It should be borne in mind that this enumeration is intended to be descriptive only; at this point in the report, no evaluation of any of these differences can be inferred.

Although only two basic types of markets exist for legal purposes, within those types are many differences, some of which are almost as significant as those separating the basic types. Especially should it be noted that the major exchanges, particularly the New York and the American, differ in many ways from the other exchanges. In the following brief description of exchanges, which is primarily for the purpose of comparison with over-the-counter markets, the focus is principally on the major exchanges in New York.

In the over-the-counter category the great varieties of components and practices also make it necessary to limit the brief discussion in this chapter to broad generalizations for purposes of comparison with exchange markets. In particular it should be pointed out that over-the-counter markets in exchange-listed securities do not necessarily conform to some of the generalizations stated.

General

In general, although exchange markets differ widely among themselves, each exchange market is relatively concentrated, homogeneous and organized. By comparison, over-the-counter markets are diffuse, heterogeneous and more loosely organized.

In the exchanges, trading is accomplished through a type of auction process. Auction markets historically were, and some of them remain, 'call' markets—an actual 'gathering' at one

time and place of potential buyers and sellers or their brokers, who match their wants and offerings of securities at the best prices obtainable on each side. In the classical market of this sort, each security is 'called' in turn during a specified trading session, thereby establishing the price for that security until it is 'called' again.

At the present time the major American exchanges are, for the most part, 'continuous auction' rather than call markets. On the larger exchanges the various securities are allocated to different localities or 'posts' on the 'floor', and buy or sell orders may be brought to the appropriate 'post' at any time during the trading session for immediate or later execution. Since there may not be matching buy and sell orders from public customers at the same moment, a continuous auction market requires mechanisms for linking the buy and sell interests during the trading sessions, and the main cog in the established mechanisms is the specialist who joins the orders in specific securities.

Over-the-counter markets exist, as organized markets, only as and to the extent that dealers elect to 'make' them, by standing ready to buy and sell for their own accounts. As many as 20 or 30 dealers, or as few as 1 or 2, or none, may be trading a particular security at any time. There is no place of congregation of buyers and sellers, and therefore the transaction of business depends on telephone and wire connections through which firms may communicate and negotiate. There are organized systems for interdealer circulation of quotations, and an intricate communications network which permits broker-dealers to keep in touch with one another, directly or indirectly, and to be generally aware of changes in quotations and in buying and selling pressures. The only vestige of a 'counter' over which business may be done is at the retail level.

On the exchanges there is a clear-cut definition of who may participate in the auction on the exchange floor, through the concept of exchange membership, or 'seats'. Furthermore, there is on most exchanges a recognized division of labour among members; the members act within a framework of regulations prescribed by their exchange and the Commission, which govern how particular functions are

to be performed and who may perform them.[8]

In the over-the-counter markets there is no institutional limit on who may engage in any particular function with respect to any or all securities, except in the broad sense that all broker-dealers in inter-state commerce must register with the Commission, and most over-the-counter broker-dealers are under economic compulsion to join the National Association of Securities Dealers. The latter, which is the 'over-the-counter markets' only officially recognized central institution, is essentially regulatory rather than operational in function.

For the exchanges there is also a clear-cut definition of what securities may be traded on each exchange, through the concepts of 'listing' and controlled 'unlisted trading privileges'. Broadly speaking, and subject to many exceptions, stocks listed on the New York and American Stock Exchanges tend to be national in scope, while those listed solely on the exchanges outside New York (often called the regional exchanges) tend to be of more local or regional interest. However, because of the phenomenon of 'multiple trading', the bulk of transactions in the regional exchanges, except for the three western mining exchanges, is not in their solely traded securities, but in securities also traded on one of the two major New York exchanges.

In the over-the-counter markets there are no similar concepts or controls, except insofar as the Securities Act of 1933 may limit initial entry into a public market.

Mechanics

In the exchange markets, the only persons present in the market-place are members, through whom, directly or indirectly, all listed securities are bought and sold on an exchange. They act primarily as agents for public buyers and sellers. On the major exchanges approximately 75 per cent of total round-lot share volume consists of agency transactions for customers and, at least for some listed securities, the market theoretically could function solely as a nexus for matching public orders, i.e., without

[8]For a classification of New York Stock Exchange members by their principal function, see ch. I, p. 12 (pt. 1), and Tables I-3 and I-4, ch. I, pp. 28–29 (pt. 1), and ch. VI.B.

any members' transactions for their own account.

In the over-the-counter markets, on the other hand, there is no similar mechanism for matching public orders; dealers making markets are the over-the-counter equivalent of the exchange as a nexus between buyers and sellers. In addition to this functional reason for greater dealer participation in over-the-counter markets, many purchases by members of the public are handled by dealers on a principal rather than agency basis; indeed, even a dealer who does not make a market in, or 'position', a particular security often handles a customer's purchase order by himself buying from another dealer and selling to the customer.

In the typical exchange transaction the public customer pays a commission as compensation to the member who acts as his broker. In over-the-counter transactions, at least in those involving purchases, the customer frequently pays a 'markup' to a dealer acting as principal, although evidence available to the study indicates that a majority of over-the-counter transactions are effected on a disclosed commission basis. Regulation of exchange commissions has historically been in terms of a minimum scale, whereas NASD concern with over-the-counter markups and commissions is expressed in terms of an upper limit. In general, stock exchange minimums tend to operate as maximums and are substantially lower than the markups allowed and usually charged in over-the-counter transactions between a dealer acting as principal and his customers.

These differences in bases of compensation are related in several important ways, as cause or effect or both, to the mechanics and economics of the respective markets. Thus, the compensation system in over-the-counter markets is said to be more conducive to 'selling' effort, i.e., stimulation of public buying, than is the exchange commission system. On the other hand, it is often said that more 'selling' is needed for the most over-the-counter securities than for most exchange securities, because the latter are, in general, more widely known and widely distributed. These statements as to exchange securities, however, are much more applicable in the case of New York Stock Exchange and American Stock Exchange securities than in the case of securities traded only on regional enchanges; and as to over-the-counter securities, it is

pointed out that agency executions appear to be relatively more frequently for less active securities than for the more active ones.

Because of the more unified and concentrated character of the exchange markets, it is generally possible for any member of the public as well as any professional to have complete and nearly instantaneous information about each transaction as it occurs; and for all transactions in the aggregate. In the over-the-counter markets, actual price and quantity usually are known only by the parties to each transaction, and aggregates are not available. Instead of the 'last price' data published for exchange securities, over-the-counter markets primarily rely on interdealer circulation of daily bid and asked quotations supplemented by interdealer wire communication of current quotations and, for a more limited list, newspaper publication of retail price quotations. Thus, the 'tape' has become a central mechanism of the major exchange markets, both as a record and as an active force, whereas in the over-the-counter markets, in the absence of any 'tape', the quotation systems and wire communications are perhaps equally crucial but have quite different use and impact.

Regulation

Whether as a cause or a result of any or all of the foregoing differences, the major exchanges historically have been, and presently are, more highly organized for self-regulation of activities in the marketplace than are the over-the-counter markets. On each major exchange there is a central organizational structure and there are multifarious regulations and surveillance procedures governing the conduct of business in the market place. The counterparts in the much more diffuse over-the-counter markets are, in general, considerably more rudimentary.

The already more organized and self-regulated exchange markets receive more elaborate and specific treatment in the Exchange Act than do the over-the-counter markets. With respect to the exchanges, the act authorizes and directs the Commission to prescribe rules for various particular functions and activities (e.g., specialists, odd-lot dealers, floor traders) and particular problems (e. g., short selling, options), and also

enumerates in some detail the subject matters of exchange rules over which the Commission has powers to require alteration or supplementation. With respect to the over-the-counter markets, the act relies primarily upon the broad concept of 'fraudulent, deceptive, or manipulative' acts and practices and the concept of the 'fictitious quotation', and authorizes and directs the Commission to define them and to prescribe means to prevent them. On the other hand, the act goes into great detail about what a national securities association's own rules are required to cover, and expressly requires that proposed rule changes be filed in advance with the Commission; it also provides for Commission review of any proceeding by such an association disciplining one of its members. Taking into account the applicable statutory provisions and the rules made by the Commission and by the self-regulatory bodies, the total combined regulatory scheme is considerably more pervasive and/or exacting in the exchange sector than in the over-the-counter sector.

As a direct result of the listing concept, most issuers of securities traded on an exchange are brought into a contractual relation with the exchange itself, and the latter is in a position to impose a degree of regulation directly on such issuers. In the over-the-counter markets there is no counterpart, except in a very rudimentary sense in connection with eligibility for NASD-sponsored quotations. Moreover, requirements—by statute and by Commission and exchange rules—as to such matters as reporting, proxy solicitation, and insiders' transactions, applicable to issuers of securities being traded, are vastly different in the two types of markets, with important consequences on choice of markets and market operations, in addition to the obvious differences in investor protection.

Similarities between Types, Differences within Types and Interrelationships

The foregoing recital, emphasizing differences in structures, mechanisms, practices, and regulations, may tend to obscure the many similarities in underlying forces, purposes, and needs as between the two types and, equally important, the many variances and gradations within each basic type. Many of the differences are actually only matters of degree, so that

individual markets, securities, and situations may fall within a gray area where distinctions are not sharp. Moreover, some of the important differences are simply historical or practical. rather than fundamental or structural, and thus are susceptible of being narrowed or widened by future technological, economic and/or regulatory developments.

There is obvious variety of needs, rules, and practices as among the 14 registered exchanges, and there is even surprisingly great variety of needs and practices as among individual 'markets' within each major exchange. In the more heterogeneous over-the-counter markets, the variances are, of course, even more substantial. On the other hand, except in the area of fraud, existing regulation consists by and large of one set of rules and standards for 'exchange markets' and a distinct and different set for 'over-the-counter markets'.

It is also necessary to recognise the various kinds of interrelationships between the two types. In the first place, there is considerable competition as to which market will become or remain the primary market—discussed in the next section—at least for many securities for which more than one market would serve. Secondly, there is some degree of choice, and therefore competition, as to whether a particular transaction will be effected in a secondary market rather than in the primary. Finally, through arbitrage, offsets, price leadership, commission structures, and otherwise, there are numerous points of interaction or interplay between markets.

Like other major institutions, securities markets in the United States are dynamic rather than static. Historically they have shown a considerable capacity to change, grow, and adapt to the needs of their times, even if not always voluntarily, not always immediately, and not always perfectly—also like other major institutions. In their present forms, each market reflects the results of shifting needs and responses. The process of change and adaptation has not ended. For example, the volume of over-the-counter trading in exchange-listed securities has grown considerably in recent years and apparently is still growing. To mention only one more development, recent improvements in communications and data processing have had notable effects on the mechanics of doing business and the allocation of business, and there are strong indications that the

full potential of these developments has not yet been realized.

'PRIMARY' AND 'SECONDARY' MARKETS—FORMS OF MULTIPLE TRADING

A security may be traded on one market or several. The several markets may consist of one or more exchanges, or over-the-counter markets, or one or more exchanges plus an over-the-counter market or markets.[9] If a particular security is traded in more than one market, the term 'primary' is generally applied to the market which has the greatest trading volume, and not necessarily to the first to be established.[10] Though it is not a term of exact meaning, 'primary' in this sense means that such market normally dominates other markets in establishing the price level for the security at any given time.

If a security is listed and traded on the New York Stock Exchange or American Stock Exchange, that market is ordinarily the primary one regardless of the number of types of other markets, but there appear to be instances in which the over-the-counter market in a listed security dominates and the exchange market is secondary; especially do the latter instances exist among bonds[11] and among stocks on the 'exempt' list.[12] If a security is traded only over the counter, there are no primary and secondary markets in quite the same sense, although a dealer regularly making a principal market for other dealers (as distinguished from handling retail transactions) is sometimes described as making a 'primary' market.

[9]On the over-the-counter side, whether or not there is also an exchange market, the several broker-dealers 'making a market' in a particular security at a given time may be considered as adding up to a single 'market' or plural 'markets'; hence, there is ambiguity in the use of the singular or plural as applied to markets for particular securities.

[10]The present use of the terms 'primary' and 'secondary' in respect of trading markets is to be distinguished from another use of the same terms, referring to the difference between all original-issue or distribution markets ('primary') and all trading markets ('secondary').

[11]See NYSE rule 396 (the 'nine-bond' rule), NYSE Guide, par. Nos. 2396 and 2396.10.

[12]See NYSE rule 394, and its supplemental list of preferred and guaranteed stocks in which members can conduct transactions off the Exchange without obtaining special permission. NYSE Guide, par. No. 2394.10.

Most of the more prominent and more actively traded corporate common stocks find their primary market on one of the exchanges, particularly the New York Stock Exchange, but some individual stocks and some categories of stocks, especially those of banks and life insurance companies, form a notable exception. The over-the-counter markets are primary for a vastly greater number of stocks, but most of these are stocks of smaller and less well-known companies and the total dollar volume of transactions in these stocks is less than that of the exchanges. Indeed, it is less than that of the New York Stock Exchange alone.

Basic Concepts and Standards Relevant to Trading Markets

What are the qualities of a 'good' trading market? It is sometimes said, in the law or elsewhere, that a market should be 'fair', 'honest', 'free', 'open', 'efficient', 'orderly', 'continuous', 'liquid' (or 'fluid'), and perhaps other things. Some of these standards or criteria are written into the Exchange Act itself, others are not. Each may de deemed a worthy objective, yet they may not all be achievable to a maximum degree at the same time in the same market. In the following pages the origin, significance, and interplay of certain of these concepts are briefly considered.

THE STATUTORY PROVISIONS

The Exchange Act uses only some of the above terms, and then only sparingly. None of them is explicitly defined, and in any case none of them is nearly as conspicuous in the statute as the constantly repeated phrase establishing 'the public interest' and the 'protection of investors' as the dominant goals. The strong congressional emphasis on these latter terms indicates that all other standards and substantive provisions, including the above criteria as they appear in the statute, are to be interpreted and applied in their light.

The maintenance of 'fair and honest markets' in securities transactions is one of the purposes of the act, as declared in section 2. 'Fair dealing' is called for repeatedly: section 6 (d)

directs the Commission to register an exchange only upon finding it has rules 'just and adequate to insure fair dealing and to protect investors'; sections 12 (b) (2) and 13 (a) empower the Commission to require that issuers shall provide such information upon registration of a security on an exchange, and such periodical and other reports thereafter, as will 'insure fair dealing in the security'. The goal of 'fair dealing' also guides the Commission's power over the rules of registered associations of securities dealers, section 15A (k) (1), and over the rules and practices of national securities exchanges, section 19 (b); registered associations' rules also must not be designed to permit 'unfair discrimination between customers or issuers, or brokers or dealers', section 15A (b) (7). A 'fair and orderly market' is the criterion for the Commission's regulation of trading by exchange members for their own account, section 11 (a). Similarly, section 11 (b) directs that specialists shall not be permitted to act as dealers more than is 'reasonably necessary * * *to maintain a fair and orderly market, * * *'.[13]

The act itself speaks only once of a 'free and open market' when, in section 15A (b) (7), it directs that the rules of registered national securities associations shall 'remove impediments to and perfect the mechanism of a free and open [over-the-counter] market; * * *'. Such rules shall also promote 'just and equitable principles of trade,' a phrase found at several points in the act.

Given the lack of statutory definitions of the foregoing terms, the Special Study obviously could not purport to interpret them definitively or authoritatively in this report. Of course such terms are best understood, and their various shades of meaning best appreciated, when met in concrete settings. Nevertheless, it may be helpful to give a brief indication of their general significance and thrust, at least insofar as they pose issues discussed in this report.

'Fair' and 'honest' presumably encompass the notion of freedom from manipulative and deceptive practices of all kinds[14] and may be regarded as positive expressions of the act's ban

[13] In a very different context, registered national securities associations must have 'fair and orderly' disciplinary procedures. Sec. 15A (b) (9).

[14] See H. Rept. 1383, 73rd Cong., 2nd sess., at p. 10 (1934); brief on the bill's constitutionality, submitted by Messrs Corcoran and Cohen,

on such practices, acts, and devices.[15] 'Fair' also presumably implies, especially in the several references to 'fair dealing' and also the reference to 'unfair discrimination between customers or issuers, or brokers or dealers,' that there be no undue advantage or preference among participants in the marketplace; i.e., that there be no unnecessary discrimination in opportunity or treatment or in access to facilities or information. As among participants within any properly recognized category—those making similar uses of, contributions to, and demands upon the market facilities —discrimination would be altogether unacceptable. As between different categories—where different uses, contributions, or demands might appropriately be recognized—differences in opportunity and treatment would be held to the absolute minimum consistent with the recognized differences. In short, a market which recognized any improper categories or permitted any unwarranted discriminations would not be considered 'fair' in the fullest sense.

'Free' presumably implies that the forces of supply and demand should operate without interjection of artificial factors. Insofar as the extraneous factors might be manipulative, the concept overlaps that of fairness. But 'free', in its ultimate sense, may go further to exclude extraneous forces of a beneficient (i.e., stabilizing or market ordering) nature. In the latter sense a completely 'free' market would be one in which the spontaneous bids and offers of buyers and sellers would be permitted to affect prices regardless of the sharpness or duration of the resulting movements.[16] 'Open' presumably implies that anyone can enter

'Hearings on H.R. 7852 and H. R. 8720, on Stock Exchange Regulation', before the House Committee on Interstate and Foreign Commerce, 73rd Cong., 2nd sess., at p. 925 (1934).

15Sec. 2 (3) declares manipulation one of the causes of those evils that the act is meant to correct : sec. 10 (b) makes it unlawful for any person to use any manipulative or deceptive device or contrivance in connection with securities transactions ; and sec. 15 (c) (1) and (2) and 15A (b) (7) forbid brokers and dealers to use any manipulative devices or practices or fictitious quotations, and direct that the rules of registered national securities associations shall be designed to prevent any such use.

16A Commission staff memorandum of 1939, discussing the Boston Stock Exchange as a primary market, described it as a 'a free and open market not serviced by a specialist; i.e., any member on the floor can

the market to buy and sell. The statutory meaning of these terms might be thought to be limited to the over-the-counter markets, since their only statutory use is the phrase 'free and open', in a section added in 1938 and applying only to such markets. However, the terms have wider usage: for example, the Senate and House reports as well as several witnesses at the hearings preparatory to enactment of the Exchange Act spoke of free and/or open markets in clearly general references; indeed, an exchange official and a representative of over-the-counter dealers both suggested that the exchanges' greater activity made them more 'free'.[17] Other examples of wider usage of the terms are a minority report of the New York Stock Exchange's Special Committee on Member Firm Costs and Revenues (1958), which referred to 'the free and open auction securities market we jealously guard * * *' and a recent statement by the president of the NYSE, that 'we have * * * consistently urged prospective investors * * * to recognize that—in a free market, subject to the laws of supply and demand—stock prices will go down as well as up'.[18]

'Orderly' presumably implies efficiency and economy of operations, but also embraces concepts of regularity and reliability of operation—'a market which does not "fold up" when the pressure on dealers becomes too heavy'[19] and the concept of avoidance of wide price swings within relatively short spans of time. In the sense of efficiency, 'orderly' might

bid for or offer the stock in any number of shares which he desires'. Interestingly, the memorandum went on to consider whether the exchange should have 'dealer specialists * * * who would perform only a dealer function in narrowing the spread which may exist between public bids and offers * * * to make a fair and orderly market'.

[17]Testimony of E.R. Grubb, president of the New York Curb Exchange, 1934 hearings, above, at p. 389 ; testimony of O.J. Troster, secretary of the New York Securities Dealers Association, id. at p. 613 ; see also id. at p. 785. And see H. Rept. 1383, 73rd Cong., 2nd sess., at p. 11 (1934); S. Rept. 1455, 73rd Cong., 2nd sess., at p. 81 (1934); H. Rept. 2307, 75th Cong., 3rd sess., at pp. 4, 7 (1938) ; 1941 report by the public governors of the American Stock Exchange, quoted in SEC, 'Staff Report on Organization, Management, and Regulation of Conduct of Members of the American Stock Exchange', p. 52 (1962).

[18]Address by G. Keith Funston, Business and Professional Women's Club of Waterloo, Iowa, Oct. 23, 1962.

[19]Testimony of E.R. Grubb, note 17, above.

include the degree of assurance, through available market mechanisms, that the highest bidders and lowest offerors do not miss each other to the disadvantage of both. In the sense of avoidance of wide price swings, 'orderly' shades into and perhaps encompasses the concept of 'continuity', discussed below; but whereas the latter term puts emphasis on price constancy from transaction to transaction, 'orderly' may also imply constancy over periods of days or weeks; i. e., a degree of stability.[20] However, neither of these latter concepts is explicitly set forth in the statute, as a definition of 'orderly' or otherwise.

NONSTATUTORY CRITERIA

The terms 'continuous' and 'liquid' (or interchangeably, 'fluid') are not statutory. As market criteria they appear to have received greatest emphasis from the exchanges themselves, particularly the New York Stock Exchange. In exchange usage the two terms appear to be closely associated with 'orderly'; indeed, they seem to be among the most conspicuous ingredients in the concept of orderliness.[21] These terms are no less relevant, however, to over-the-counter markets, even though the contributing factors and the potentials may differ between as well as within the two types of markets.

[20]Compare 6 S.E.C. Ann. Rep. 91 (1940).

The close relationship of the terms 'orderly', 'continuity' and 'stability' is illustrated in the 'Saperstein Interpretation' (discussed more fully in ch. VI.D.3.b and 6.b), interpreting the Exchange's rule about specialists' transactions being effected only when 'reasonably necessary to permit such specialist to maintain a fair and orderly market':

'* * * a transaction cannot be deemed reasonably necessary for the maintenance of a fair and orderly market within the meaning of the rule if it is not reasonably calculated to contribute to the maintenance of price continuity and to the minimizing of the effects of temporary disparity between supply and demand * * *. Transactions of (certain) types may, within the meaning of the rule, be justifiable * * * only when they are an essential part of a course of dealings designed to promote the continuity and stability of the market * * *' [Securities Exchange Act release No. 1117 (Mar. 30, 1937)].

[21]Since the degree of continuity or liquidity for exchange-traded securities may depend, to a greater or lesser extent for particular securities, on the amount of specialist participation, these concepts are especially prominent in discussions of such participation.

'Continuous' implies that a series of consecutive separate transactions, even though involving price changes, will involve minimum price variations or deviations.[22] While continuity thus refers to changes from the immediately preceding price level, it is an open question whether the term implies anything about the quantity traded at any given level or the extent to which a price trend may continue in one direction. Stated another way, the line between the concept of 'continuity' and the concept of 'stability', or between maintaining a 'continuous' market and 'stabilizing' a market, is not a clear one.[23]

'Liquid' implies that a willing seller can readily (or perhaps immediately) find a buyer, or vice versa, at a mutually agreeable price. Thus, securities are generally said to be more liquid than real property, personal notes, or similar asset. Again, to what extent the term implies that a transaction occurs at a price closely related to current intrinsic worth is an open question.[24]

THE BALANCING OF OBJECTIVES

Although all of the above criteria may individually seem worthy, there is inevitably some degree of conflict among them.

[22]This use of the term is, of course, quite distinct from the previous reference to a 'continuous auction' market.

[23]The House report preceding enactment of the Exchange Act expressed reservations about continuity: 'The importance of active, constant trading can readily be exaggerated. A relatively stable market over a period is of much greater importance to investors than a fictitiously stable market that involves no more than one-eighth of a point spread between sales but results in wide fluctuations over days or weeks. The market's liquidity depends upon its relative stability and not upon the spreads between monetary sales.' H. Rept. 1383, 73rd Cong., 2nd sess., at p. 14 (1934). But see also Twentieth Century Fund, 'The Security Markets', pp. 294–96 (1935).

[24]For a discussion of continuity and liquidity as concepts and with particular reference to 'dealer' activities on exchange markets, see SEC report on 'The Feasibility and Advisability of the Complete Segregation of the Functions of Dealer and Broker', pp. 21–22, 36, 98–102 (1936). See also Twentieth Century Fund, 'The Security Markets', pp. 25–26 (1935), and Senate Committee print, 'Letter from the President of the United States to the Chairman of the Senate Committee on Banking and Currency', and accompanying committee report, 73rd Cong. 2nd sess., pp. 5, 16 (1934).

In many contexts and circumstances, therefore, some degree of balancing and reconciling is required, presumably with a view to 'the public interest' and 'protection of investors'.

The point may be illustrated in terms of members' participation in the auction markets. As stated above, certain transactions of members for their own accounts are required and/or are claimed to serve the needs of the markets—to provide continuity and liquidity, or even, in the case of very inactive securities, to make it possible for a continuous auction market to exist. From this point of view, members' participation is presumably to be welcomed and fostered, since the less of it there is, the less 'continuous' or 'liquid'—and therefore 'orderly'—may be the resulting public market. On the other hand, as mentioned above, exchange members have inherent advantages over the public—especially in extent and immediacy of information—when they buy or sell for their own accounts. From this point of view, the larger the participation by members for their own accounts, the more impairment there may be of absolute 'fairness' for public investors. Likewise, and particularly if the members' participation is intended to achieve continuity or fluidity, 'freedom' of the market as a pure reflection of public supply and demand may be impaired.

This sort of dilemma is of many varieties and takes many forms in the securities markets—by no means limited to the question of member participation in the exchange markets—and the attractiveness of choosing one horn or the other may vary from context to context. An appraisal of the rules and practices of the securities markets requires continual weighing of the various objectives in relation to each other and a constant recognition that their balancing is a complex, delicate one that may lead to different answers in different markets, or even in different contexts within the same market. Stated another way, the more difficult substantive questions arising in a study of the adequacy of rules and practices, or in statutory administration generally, can rarely be answered by simple reference to any one or even several of the criteria mentioned; separately or in combination, they at best supply guidelines within which there are large areas for definition of policy on concrete problems.

'DEPTH' IN RELATION TO CONTINUITY AND LIQUIDATION

A somewhat different kind of concept—not a criterion of a total market in the same sense as the others, but important in the description or evaluation of the markets for particular securities—is that of 'depth'. Broadly speaking, this term refers to the quantity of buying and selling interest and the potential activity on each side of the market. It may refer to such interests and activity on the part of the public only; that is, excluding the professionals, or it may refer to the combination of public and professionals. Again, it may be used in an immediate and therefore ephemeral context; e.g., the depth of a specialist's book at a given time, or it may refer to a more or less continuous attribute of market; e.g., the characteristic depth of the market in General Motors common as compared with that of a relatively obscure and inactive stock.

If considered in the sense of public (i.e., excluding professional) interest and activity, depth is usually thought to be a product of several different factors, the most important of which are (i) the total amount of the class of securities outstanding, and (ii) the breadth of distribution among the general public, exclusive of amounts concentrated in the hands of controlling persons and other 'permanent' holders of large blocks. Subsidiary but still important factors, tending to be of a somewhat more transistory character than the foregoing, are (iii) the prominence and prestige of a particular company, (iv) current economic and social developments leading to popularity or unpopularity of a particular company or industry among public investors, (v) broker-dealer soliciting activity, (vi) balance between trading and investing activity, and (vii) price level per share. Depth may also have a geographic aspect: (viii) the concentration of public interest and potential activity in a particular locale.

The listing requirements of exchanges all reflect, in one degree or another, a concern for the quantity of stock outstanding and the floating supply; i.e., the principal indicia of depth of public interest on a long-term basis. This is at least partly in recognition of the fact that the continuity and liquidity of an exchange market, as a continuous auction market, ultimately depend on the depth of public participation and the extent to

which that can be, and is, supplemented by specialist participation. In other words, unless there is an adequate base of public interest and activity, either an undue burden may be placed on the specialist system or continuity and liquidity will be lacking. While this leaves room for considerable variation among listed securities, there is even greater variation in the continuity and liquidity provided, by the depth of public interest plus dealer participation, for the wide variety of securities in over-the-counter markets.

PRACTICES IN FOREIGN SECURITIES MARKETS

Before proceeding with a more detailed examination of existing rules and practices of American trading markets, it is perhaps worthy of reminder that no particular rule or practice is immutable, inevitable, or universal. This is demonstrated by the many differences among American markets and the many changes in their rules and practices that have historically occurred, as already mentioned. It is demonstrated also by the many differences between rules and practices of American securities markets and those of nonsecurities (principally commodity) markets in this country and of securities markets elsewhere.

European stock markets, for example, provide illustrations of differences in a number of important areas, a few of which are mentioned below. In the actual conduct of trading, some of these markets use various forms of an oral 'call' system; some provide for limitations on the extent of price variations in a given period; some permit bankers to act as brokers. The role of the government may be greater or smaller and may be felt in different ways, such as through government-appointed officials who are responsible for matching orders; the functions of the trading professionals may be separated or combined along different lines; and commission rates and rate structures may, of course, differ substantially.

While securities markets outside the United States are obviously beyond the scope of the Special Study and this report, a brief description of some of the distinguishing characteristics of the London Stock Exchange, as one example, supplies a useful background for consideration of the American markets.

Of all the European exchanges, the London Exchange does

the greatest amount of trading and has the most elaborate trading mechanisms.[25] Almost 10,000 different stock and bond issues, British and foreign, are traded. A limited number of local issues are traded to a much lesser extent on the 21 other exchanges located elsewhere in the British Isles, there being no British over-the-counter market, as such. Among exchange-traded securities, however, there is a distinction between issues of securities that are 'quoted' and those that are not, the former being somewhat akin to our fully listed category and the latter being roughly comparable to our (now restricted) unlisted-trading category. Any two members of the London Exchange can obtain permission to trade any security on the exchange, without a listing application by the issuer, and such unlisted trading fills the role of over-the-counter trading as known in this country. This arrangement is designed for occasional transactions, and if a market develops, application for full quotation is insisted upon. Dealings may also take place in securities which are listed on certain other recognized stock exchanges.

The London Exchange is a voluntary, self-regulatory institution, much like the American exchanges in this respect but not subject to the supervisory control of a governmental regulatory commission. It is composed of some 350 member firms, all of which are partnerships and all the partners in which are individually members of the exchange. Strict rules govern admission to membership, although there are no entrance examinations as such.

Members must reapply for membership annually and at that time must state whether they will act as a broker or a dealer (known as 'jobber')—they may not act in both capacities. Brokers receive their income in the form of commission fees and deal directly with the public, as agents. They buy and sell through the jobbers, who make their income by trading particular securities as principals and who may not deal with the public. The jobbers perform a function somewhat similar to that of the specialists on the New York Stock Exchange in that they 'make markets', but there are several significant differences:

[25]The Special Study is indebted to W. S. Wareham, secretary, Share and Loan Department, London Stock Exchange, for reviewing the material about the exchange.

The jobber does not have to make trades and has less responsibility for maintaining markets. On the other hand, he is permitted to make a market in any stock he chooses, and as many as 28 jobbers have been observed making markets in one particular security at one time. There is no differentiation between round lots and odd lots in jobbers' transactions. The number of jobbing firms has fallen from 175 to 81 in the past 10 years, apparently owing in part to British tax policies.

Prices at which transactions occur are usually, but not always, reported by the brokers and jobbers. The reporting of prices is not compulsory and the announced prices are not necessarily those at which the trades actually took place. While the number of transactions is reported, there are no figures as to the number of shares traded in particular security, volume figures being a jealously guarded secret. With regard to dealings, there is much less emphasis on full and rapid dissemination of information, either as to transactions on the exchange or as to the issuers of the securities traded.

Members of the exchange may not advertise in newspapers although the exchange itself advertises and, much like the New York Stock Exchange, is seeking to broaden share ownership among the general public. Advisory literature issued by brokers may be sent only to customers of the firm.

British banks are far more involved in the securities business than is the case in this country, some brokers dealing almost exclusively with banks. Since exchange members do not have offices away from the vicinity of the exchange, public investor contacts outside of London are frequently made through branch banking offices. A large amount of the business outside London, however, is handled initially by members of the 21 stock exchanges situated in major provincial cities and by members of the Provincial Brokers Stock Exchange in some 110 smaller towns, most of which business is channelled to the London Stock Exchange. Exchange members are permitted to allow a return of commission (not exceeding 25 per cent) to banks, and block discounts are allowed.

Short selling is not governed by special regulations. Payment for stocks and delivery often does not have to be made for as long as 3 weeks, and thereafter settlement can be further

deferred through payment of a fee, an arrangement known as 'contango'.

The London Stock Exchange exemplifies many differences from prevailing American practices but, as suggested earlier, it by no means illustrates all the variations that can be found. Needless to say, the variations from country to country often can be explained by differences in maturity of the economies and in heritages of custom and tradition, so that operations or regulations successfully existing in one country may not function with equal effectiveness in the economic and political environment of another. To refer to variations of rules and practices in other markets is by no means to suggest a preference for any of them; it is merely to suggest that a broad study and investigation of the adequacy of existing rules and practices should not be blind to other possibilities.

Urgent Questions about the Stock Market*

Roger F. Murray

Roger F. Murray raises some important questions concerning the efficacy of the stock market with regard to the basic functions expected of it. These questions are of central importance in judging the performance of stock markets in any country. Answers to these questions would determine the sort of changes needed in the methods and operations of the market.

Editor

Four central issues raised by the SEC Special Study deserve top management's attention:

(1) Millions of people are having their first experiences with 'owning a share in the future of America'. It is essential that they receive fair treatment in this venture. *Are they receiving such treatment in the securities markets today*?

(2) The stock market's behaviour can have a powerful influence on the course of economic activity. *Is it exerting a healthy influence*?

(3) The market renders the final verdict on the quality of managerial performance. *Are the market mechanisms able to make these verdicts accurately*?

*Roger F. Murray, 'Urgent Questions about the Stock Market', *Harvard Business Review* September-October 1964, pp. 53–59.

(4) The market dictates the cost and the availability of new equity capital. *Is it doing this job effectively?*

VITAL FUNCTIONS

Let us examine each of these crucial questions in turn. We will then be in a good position to consider some general goals and problems of regulation.

1. ARE INVESTORS RECEIVING FAIR TREATMENT IN THE SECURITIES MARKETS TODAY?

Erratic price changes, speculation in new issues, conflicts of interest, and 'boiler room' operations in the sale of questionable securities occur just frequently enough to raise questions about the adequacy of investor protection from sharp and fraudulent practices. Policing the activities of more than 5,000 firms is an unending task for public and private agencies. Despite the regulatory arrangements created in the 1930's, the postwar growth in market activity and the spectacular increase in the number of registered representatives from fewer than 30,000 in 1950 to nearly 100,000 in 1962 have posed a whole new set of problems in enforcing high standards of conduct for the highly decentralized securities industry.

In taking a fresh look at the protection afforded investors, the SEC Special Study critically examines all aspects of the markets in which stocks change hands through channels open to the public. The focus, in the words of the letter of transmittal from Willian L. Cary, Commission Chairman in 1963, is on efforts 'to strengthen the mechanisms facilitating the free flow of capital into the markets and to raise the standards of investor protection, thus preserving and enhancing the level of investor confidence'.[1]

Bones of Contention

With the great postwar growth in the stockholder population, from an estimated 6.5 million in 1952 to an estimated

[1]Ibid., Part I, p. iv.

17 million-plus currently, it is obvious that investors' confidence must be preserved if the markets are to continue to grow and to function effectively. The current controversies over regulation do not question the need for it. Rather, the debate rages over such issues as:

- The extent of the reliance to be placed on *self*-regulation by the stock exchanges, member firms, brokers, and dealers, as contrasted with regulation by the SEC.
- The possibility that unduly restricting the operations of those who make markets in securities will reduce the breadth and liquidity of the market for equities.
- The specific contribution of different market participants to orderly transactions in outstanding securities and to the flotation of new issues.

The Commission's critical questioning of accepted views on these issues has stimulated a lively debate, in which studies and experts' reports have been marshalled to support divergent opinions.

Despite the welter of charges and counter-charges, however, the basic questions have clearly emerged. Should there be closer policing of the manner in which orders are executed on the stock exchanges and in over-the-counter markets? Does the public receive fair treatment, including full disclosure of the transaction costs involved? Do the 'hot new issue' episodes of 1961 suggest that there should be additional safeguards for the unwary and uninformed members of the new generation of stock buyers.

The great growth of the stockholder population in the course of a long bull market is a measure of the newcomers to the stock market. Many become stockholders in the companies which employ them or acquire mutual fund shares, but there are many others, not in a position to understand and appraise the risks involved, who are struck by speculative fever. While regulation cannot eliminate ignorance and greed from the influences at work on newcomers to the securities markets, it can reduce the extent to which they may be exploited by predatory securities salesmen.

Potential Impact on Business

However they enter the marketplace, the new generation of common-stock buyers represents a group of people experiencing their first acquaintanceship with the role of the stockholder. Under the right auspices this should be a rewarding experience, constructive for the development of widespread participation in the American business system. Under the wrong auspices this could become a bitter experience. The treatment afforded these new stockholders is vitally important, for the simple reason that they are apt to blame the business system more than they do the securities industry or their own greed for any misadventures in the risk-taking activity of equity investment.

2. IS THE MARKET EXERTING A HEALTHY INFLUENCE ON THE COURSE OF ECONOMIC ACTIVITY?

No sketch of the economic environment or of the business outlook is complete without an observation of stock market trends. Rising prices—an expression of confidence and optimism—are conducive to favourable spending decisions by business and consumers. The reputation of the stock market for being a leading indicator of business conditions also gives it special importance. The stock market has led economic activity at 17 out of 20 business-cycle peaks. Since it typically leads the business cycle by about five months, a rising market acts as a tonic to expectations for the future as well as for the current course of economic activity.

More crucial, perhaps, is the devastating impact of protracted declines in stock market prices. The 1929 crash unquestionably contributed to the subsequent depth of the business contraction which followed. Closer regulation of stock-market trading practices, by preventing some of the pre-1929 excesses, might have moderated the extent of the post-1929 debacle. It is probably not altogether a coincidence that the greater stability of stock prices in the postwar years accompanied or preceded periods of relatively stable business conditions.

Destabilizing Effect

No doubt, expectations as to the outlook for business and profits influence the trend of stock prices. The trend of prices, in turn, either reinforces optimism or dampens the exuberance of business and consumer attitudes. Since instances of manipulation and market imperfections exaggerate the cyclical swings in stock prices, their reduction or elimination is a logical objective of economic policy and a potentially important contribution to the goals of economic stability and growth.

This point was specifically raised by the events of May 28, 1962, and subsequent hectic days in the securities markets. While not conclusive, the evidence is at least persuasive that activity in 'hot new issues' of marginal quality, reaching a crescendo during 1961, contributed to a speculative bubble of overvaluation in common stocks.[2] The impact on high-quality listed issues of this particular market break was substantial (usually described as a decline of 20% to 25%), even though it was only about half as great as the typical precipitous decline in unseasoned stocks.

Widespread concern in government and business circles about the business outlook was generated by the 1962 break in stock prices. Advocacy of early tax reductions became more vocal, along with the usual spate of reassuring statements. The pace of the business expansion did slow down, as evidenced by a rise in the Federal Reserve Board index of industrial production of only 1.4% between June and the following February and a rise in deflated gross national product of only 1.6% between the second and fourth quarters of 1962. While the pauses in the economic expansion cannot be attributed just to the stock market break, it is evident that the abrupt decline in prices was sobering to expectations.

Although the links in the chain of reactions are not always clear or susceptible of specific proof, studies of the May 1962 stock market suggest plainly that the 'public' heavily weighted with relatively new and inexperienced small investors, contributed to the extent of the decline and to the atmosphere

[2]Chapter IV of the SEC Special Study provides a fascinating review of many aspects of 1959-1961 new-issue activity; Part 1, pp. 475-628 and Appendices.

of near-panic which prevailed.[3] It is likely that many of these people had also been caught up in the speculative fever which had afflicted the new-issue market during the preceding year or more. Thus, on a happily modest scale, we witnessed a demonstration of how imperfections in the market mechanism can create destabilizing influences.

We might conclude from recent history that a more drastic reaction in a period of less strongly based economic expansion could generate serious consequences. At a minimum, we have been reminded that the tight regulation of stock market credit will not, by itself, prevent the growth of destabilizing influences.

3. IS MANAGEMENT PERFORMANCE BEING APPRAISED CORRECTLY?

A sound goal for management in the operation of a business is to maximize the long-run value of the enterprise. An objective test of performance for a publicly owned corporation, therefore, is the market's appraisal over a period of time. If market prices tend to fluctuate around some 'intrinsic' or 'investment' value of the going concern, we should be able to interpret market quotations over time as a series of judgments on how well managers are succeeding in achieving this goal.

In many ways we commonly assume that the market *is* an accurate valuator. Businessmen make this assumption when they—

...grant stock options at market prices to key employees;
...make shares available for purchase by employees;
.. exchange shares for property in mergers and acquisitions;
...sell or liquidate a business;
...establish the equity base as a factor in determining borrowing capacity.

In actuality, such assumptions are valid only to the extent that the market mechanism functions to reflect fundamental factors in the corporation's history.

[3]Ibid., Chapter XIII, Part 4. See also, New York Stock Exchange, *The Stock Market Under Stress*, March 1963,

Short-Term Failures

The question now before us is: Does the market mechanism function this way in fact?

The record of the stock market, viewed over a *long* period of years, is reasonably satisfactory in its role of valuing businesses. But in specific cases and over shorter spans of time, performance has been less impressive. Even the great improvement in sources of information and in the methods of security analysis has not materially increased the precision of the market as a valuator. In a year of only moderate price fluctuations for the market as a whole, fluctuations in price of 25% and 30% for well-established companies are commonplace. Obviously, the change in the fortunes of a large company is rarely of this dimension in a 12-month period. Successive expert appraisals of privately owned enterprises would show no such erratic fluctuations.

Valuations made by the market are sufficiently imprecise to afford many opportunities for the profitable shifting of investment funds from stock to stock and from one industry group to another. Such operations presumably reduce disparities and improve the accuracy of market appraisals. They take place, however, only when the breadth and responsiveness of the market facilitate transactions in substantial volume. Those who perform this arbitraging function to reduce undervaluations and overvaluations may be long-term investors, traders, or speculators.

Obstacles to Better Pricing

The principal obstacles to relating the prices of shares more closely to long-term values are:

- Ignorance of the enterprise being valued.
- The propagation of misinformation.
- The manipulation of prices and activity to obscure the real judgment of buyers and sellers.
- The stampedes created by fads and fashions among participants in the market.
- The strange philosophy that a well-managed company is cheap at almost any price within wide limits, which produces

exaggerated valuations of successful enterprises (while, on the other hand, moderately successful ventures are often very conservatively valued, and poorly managed companies are likely to be undervalued).

The equally strange philosophy that dissatisfaction with management should be expressed by selling the shares, rather than by doing anything to improve the situation, which can produce dramatic instances of greatly depressed prices.

In a very real sense, prices are presumed to register the judgments of informed people about managerial accomplishments and are ultimately decisive in determining who will continue in office and how they will be compensated. If such power is to be exercised by the market in a manner likely to improve the effectiveness of corporate managements, it must be based on the kind of market mechanism in which valuation factors, not manipulation, predominate.

Short-run Temptations

Market valuations will be fair only if the participants act on the basis of reasonably complete information, which only management can provide. But management, since its own performance is being judged, is naturally tempted, consciously or unconsciously, to put a favourable interpretation on current and prospective developments. At worst, disclosure of unfavourable factors may be suppressed. Happily, investors are not long beguiled by either smooth talk or elaborate 'information' programmes designed to tout their shares.

Unfortunately, company managements sometimes become unduly concerned over their performance rating as expressed by the market. A tape-watching management, absorbed in short-term fluctuations in its stock's price, may be inclined to sacrifice long-run objectives for current advantages. Detection of this kind of attitude is not an easy assignment for the security analyst, but eventually it will become apparent to the close observer and to investment public. The rewards to the promoter are short-lived because the market reserves its accolades for those managers who view their company in the same perspective as the long-term investor. The 'blue chip' rating is highly prized, but earned only over an extended period.

4. DOES THE STOCK MARKET EFFECTIVELY PRICE NEW EQUITY CAPITAL?

In the process of valuing a publicly owned corporation, the stock market is determining the cost and availability of additional equity capital. The most obvious case is the market's role in setting the price at which additional shares can be sold in limited amounts. The more important case, in these days of heavy reliance on retained earnings to finance expansion, is the market's function in helping management to determine the cost of capital for investment decision making purposes.

In these aspects of business finance, we see the market serving its economic function in the allocation of capital (and therefore of real resources) to the most efficient uses. This key role of the stock market is often forgotten because new equity financing has been small in volume during recent years. Yet the market mechanism is constantly at work guiding investment into productive channels.

All such calculations assume that the valuation process truly reflects the expected level of earnings with allowance for risk and uncertainty. Attempts at quantifying the determinants of the cost of capital imply a degree of precision in the process of valuation which is more of an ideal than a reality. The closer the market mechanism can come to valuing the corporate enterprise, the more accurate will be the basis on which decisions are made.

Valuation of New Firms

An especially troublesome problem is the valuation of new firms:

●The new-issue market in 1961 illustrates the vagaries of a market in which the public's appetite becomes ravenous under intensive stimulus from eager underwriters. It is difficult to find any systematic pattern of valuation in the many promotions of that year. It is also far from clear that the underwriters had made careful selections of companies ready to go public for the first time.

●The SEC Special Study surveyed a sample of 960 small

companies going public from 1952 to 1962. The results cast some doubt as to whether these companies were ready. Some 37% of them could not be located or were inactive, liquidated, or in reorganization. Another 24% were still in business but operating at a loss. Almost 5% had been merged with other companies. This left only 84% operating at a profit. In a sample of offerings of 'promotional' companies (i.e. those newly formed or not yet showing any accumulated profits), only 14.5% came from organizations operating even temporarily at a profit.[4]

Perhaps the market is doomed to a poor record in appraising unseasoned ventures. This may suggest that Small Business Investment Companies or private venture-capital companies should undertake the seasoning process. It is obviously desirable to keep open the channels for high-risk undertakings, but the public market may not be equipped to make rational selections from a wide range of specialized risks.

Real Estate

Another area in which the securities markets may fail to work effectively is real estate finance, in which the specialized valuation process is foreign to most security analysts. Real estate syndicate offerings to the general public, aggregating several billion dollars, showed spectacular growth through the spring of 1962. A share in the ownership of real property is a logical medium for public investment, but deficient governmental regulation and the virtual absence of self-regulation produced some highly questionable allocations of capital.

Over-all Record

However, pointing to these failures in specific cases should not blind us to the effective working of the marketplace in dealing with the great bulk of valuation problems. Despite its imperfections, the evidence of the market's effectiveness in allocating capital to highly productive uses recommends our reliance on it in preference to any known alternatives. My

[4] SEC Special Study, Part I, p. 551.

aim in dwelling on some of its observed deficiencies is simply to enable us to secure even better performance in the future.

Goals of Regulation

The goals of regulation to assure a superior performance of the stock market in the four major functions just described can be simply stated:

1. To assure full disclosure of information as a basis for rational buying and selling decisions.
2. To assure fair and equitable treatment for investors in the execution of their transactions.
3. To encourage investment in equity securities by giving them the characteristic of liquidity.
4. To eliminate distortions and erratic fluctuations in prices which might contribute to general economic instability.
5. To provide an effective channel through which new capital can be economically raised.

In short, the objectives of regulation are to facilitate a type of risk-taking in which the risks relate to the real variables of a competitive enterprise system rather than to faulty functioning of the market mechanism. When controversy rages over specific recommendations for change in the market mechanism, it is a good idea to keep these objectives in mind. They are invaluable reference points.

CASE FOR SELF-DISCIPLINE

In seeking the five goals just listed, the Congress has firmly committed itself to heavy reliance on self-regulation by the participants in the securities business—the stock exchanges, the National Association of Securities Dealers, and other groups. The case for self-regulation rests on a number of assumptions:

- It is more practical for a widely dispersed and diversified business.
- It is more likely to enlist expert knowledge and close familiarity with the business than is regulation by a remote government agency.
- It should enable organizations in the business to move

more promptly to meet changing conditions and new problems.

- It may produce a self-discipline which encourages not only voluntary compliance but also obedience to ethical standards beyond those established by law.

By their nature, security transactions involve great reliance on the probity of the participants. More than mere observance of specific rules and regulations is necessary to establish a high standard of conduct. Thorough examination of the qualifications and backgrounds of new entrants into the business, adequate training of registered representatives and salesmen, and close supervision over the advice given to customers—these are illustrations of requirements which can be better fulfilled by self-discipline enforced by strong industry leadership than by statute or administrative regulations.

Accordingly, the SEC was established to regulate specifically *only certain aspects* of the securities business. It was given the further responsibility of supervising and overseeing self-regulation. In this respect, its function has differed from that of those governmental commissions which assume the complete regulatory responsibility. The unique SEC system has worked rather well for the last three decades, and both the Commission and the industry have reaffirmed their confidence in it. Nevertheless, the spectacular growth in the volume of activity and in the number of individuals involved as buyers and sellers of securities has raised knotty questions about the effectiveness of both the Commission and the industry's self-regulating agencies in dealing with new problems. The differences of opinion arise less from matters of principle than from issues of fact and interpretation.

PROBLEMS AND UNCERTAINTIES

Numerous questions arise regarding the desirability of closer regulation by the industry or the Commission, because the securities markets involve a wide range of participants other than investors seeking to exchange shares of stock for cash or for other shares.

Individual Activities: On the New York Stock Exchange, the American Stock Exchange, and other exchanges, for example, brokers, specialists, odd-lot dealers, and floor traders are all

participating actively in making a continuous auction market. How do these individuals contribute to the behaviour of prices? By taking long and short positions, do they operate to increase the stability and liquidity of the market? Do they, as speculators and traders, fill gaps in the continuity of prices, provide breadth to the market, and dampen erratic price fluctuations? Can they serve the investing public well in the course of their profitseeking activities for their own accounts?

Detailed study and close monitoring of their activities are required to answer these questions. Even with such information at hand, reasonable men may differ over its interpretation. Hence the controversies over the floor traders, the specialists, the handling of odd-lot transactions and short selling.

New Issue Market: Practices in the new issue market raise questions beyond the matter of full disclosure. What about the qualification for entry into the underwriting business. Since new issues are sold to the public by salesmen, what should be the level of training required of them? How can their activities be supervised in a widely dispersed network of dealers? How does one distinguish between hard selling and high-pressure selling? What is reasonable compensation for underwriting and distributing services? What are the implications of sponsoring the entrance of a new enterprise into the public market.

Over-the-Counter Market: The secondary market for unlisted stocks (over-the-counter) also presents a wide range of questions. Is the customer fully informed regarding his broker's or dealer's position and compensation? Are published quotations adequate? Should unlisted companies be required to meet higher standards of disclosure and reporting when the public becomes a substantial holder of their shares?

Advisory Services: The growth of market letters, advisory services, and a wide range of publications for individual investors has raised a number of questions regarding the propriety of such communications. As another aspect of the massive selling effort required in the merchandising of securities, these materials may be helpful sources of investment information or simply sales literature disguised as analytical reports. Who is to draw the line of demarcation between the tipster sheet and the serious investment research effort? To what extent is the

purveyor of investment advice obligated to disclose his interest in the securities he discusses.

Conclusion

Not a single one of the regulatory problems described is easily answered. Nor is it usually clear whether or not self-regulation needs support from the regulatory authorities. Under the circumstances, there is no alternative to a careful verification of the facts, a dismissal of sweeping generalizations in favour of the identification of specific problems, and a dispassionate view of the workings of all parts of the market mechanism. Calling the SEC a power-hungry bureaucracy, or the New York Stock Exchange a private club, really accomplishes little in the way of improving the functioning of the stock market. Rather, the issues are complex but susceptible to analysis, technical but of general interest, and matters of private concern but affected by the public interest.

Some of the most important topics emerging from the current round of studies include:

- The operation of the auction markets on the stock exchanges.
- The operations of over-the-counter brokers and dealers.
- The qualifications and resources of brokers, dealers, underwriters, salesmen, and investment advisers.
- Selling practices.
- Conflicts of interest.
- The availability of information for investment decisions.
- The strengths and weaknesses of present regulatory arrangements.

Healthy as such studies may be, they will bog down in legalistic technicalities unless there is clear recognition of the broad public interest in the effectiveness of the market mechanism. It is especially important that consideration be given to the dynamic changes taking place in the demands placed on the market. On the one hand, our progressive income and estate-tax structure is constantly redistributing large concentrations of ownership into the hands of many middle-income investors. On the other hand, institutional investors are playing an increasing role in the ownership of equity securities on

behalf of the great majority of American families.

The markets are called on to function at both the wholesale and the retail level. Price stability and liquidity are needed to accomplish the ready transferability of shares and an orderly, rational valuation of corporate enterprise. These functions are so important to our goals of economic growth and stability that the stock market is, in truth, everybody's business.

21

Stock Market Liquidity: How Much? For Whom?*

L. C. Gupta

This paper raises certain fundamental issues about the functioning of the stock market, with particular reference to the market for equities. It advocates an entirely new and more rational approach to the whole concept of stock market liquidity and critically examines the system of forward trading which was in vogue on the Indian Stock exchanges.

Editor

The basic function of the stock market is universally accepted to be to provide ready marketability or liquidity to the holdings of securities. Implicit in this concept of liquidity is the concept of price continuity which means that consecutive transactions will not involve sudden and sharp price variations. This function is held to be so vital and central to the whole purpose of a stock market that the degree of success achieved in its performance is often regarded as the fundamental test of its efficiency. Maximisation of liquidity then becomes the goal of stock market organisation; and the ideal stock market is regarded as one which can provide

*These ideas were developed in the course of a UGC-financed research project on the volume and characteristics of stock market trading. Mr. J.K. Rohatgi collaborated in the collection and analysis of data originally published in the *Economic and Political Weekly*, Vol. 8, No. 34 (25 August, 1973), Review of Management, pp. 85-96.

instantaneous and unlimited liquidity. The main justification for stock market speculation is based on this reasoning.

We shall argue in this paper that the concept of desirable liquidity in the stock market has been carried to an absurd length and that the liquidity resulting from forward trading in shares is redundant, spurious and lop-sided.

How Liquid Need Equity Investments Be?—The Investor's Viewpoint

Liquidity is required to enable the investor to convert his holding into cash in case of need. A security ought to possess the attribute of liquidity to be attractive as an investment for the ordinary investors. We shall, therefore, first consider how much, and what kind of liquidity does a genuine investor normally expect from his equity investments. We are expressly considering the viewpoint of the genuine investor as opposed to that of the pure speculator.

A genuine investor is supposed to invest for a relatively long period for the sake of income (including dividend as also capital gain based on growth) as distinguished from a purely trading profit arising from short-run price fluctuations induced by shifts in market sentiment. How liquid would he expect his equity investment to be before he agrees to make such investment? Has it necessarily to be instantaneously liquid? Who benefits most from instantaneous liquidity—the investor or the speculator?

It is only reasonable to assume that a prudent long-term investor in equities would have provided for his immediate cash needs by holding cash balances and near-cash assets like fixed deposits, and only if he has a surplus of cash would he consider it wise to hold long-term investment, such as equities. Even the contingent cash needs which may arise all of a sudden will have been provided for, upto an extent, in the above manner. This assumption is in agreement with the usual three-fold classification of the motives for holding liquid cash viz., the transactions motive, the precautionary motive and the speculative motive.

If the above assumptions about the genuine investors' behaviour and attitude are correct, the degree of liquidity that he

would normally expect in the case of an equity investment is not 'instant' liquidity, but moderate liquidity; he would ordinarily feel satisfied if he can hope to convert his equity holding into cash, not necessarily instantaneously, but within a relatively short period of, say, 2 to 4 weeks. Were it not so, the equity shares of most companies, with the exception of a handful, would have no appeal to him as an investment.

Experience indicates that a prudent investor would not only allow for a short waiting period for realisation of his cash from his investment, but he should also be prepared to tide over prolonged periods of stock market depression which no amount of liquidity can eliminate. Hence, in the context of the equity market and looked at from the investors' viewpoint, we should consider the condition of 'ready marketability' to be reasonably satisfied if the equityholdings are potentially convertible into cash within something like 2-4 weeks. It will be unreasonable for any investor to suppose that his equityholdings are as good as cash; nay, they are better, because they give him an attractive return, while cash yields nothing. An investor cannot eat his cake and have it too.

From the above, it should be clear that a genuine investor looks not for 'instant' liquidity but a reasonable degree of liquidity. It is the speculator who wants instant liquidity because he wants to be in and out of a security during the same day, often in the matter of a few hours. Hence, unlimited liquidity would benefit the speculator most. This is the reason why the activity of speculators is almost wholly concentrated on a handful of most actively-traded stocks. Most speculators would not touch the inactive stocks with a pair of tongs. We, therefore, find that even though the argument for maximising liquidity of stocks is advanced on behalf of investors, the genuine investors' own need in respect of liquidity is of a limited nature.

An aspect of liquidity is the size of individual transactions which can be effected without disturbing the market. This has necessarily to be considered in relation to the distribution of equityholdings among the shareholders of individual companies.

An important fact to be borne in mind is that the size of individual holdings in any company varies over an extremely wide range. At one extreme are the controlling blocks often forming a high proportion—sometimes more than a half—of a

company's equity. Such blocks are usually held tightly and are not the subject of market dealings in the ordinary way. Most companies, including the big ones, in India have fairly large controlling blocks ranging in most cases above 25 per cent of a company's equity.

An equally outstanding fact about the structure of the Indian share market is the large institutional holdings of the public financial institutions, the most important among which are the LIC and the UTI. The development banks in many cases have also come to hold sizeable proportions of the equity of many companies as a result of underwriting operations. According to a survey carried out by the Bombay Stock Exchange covering 515 listed companies for the year 1968-69, the ten largest equityholders in each of these companies held as much as 56 per cent of the total equity capital on an average.[1] There are indications that this percentage has been on the increase because of a trend towards greater concentration of shareholdings in the hands of monolithic public financial institutions. The institutional holdings are also held somewhat tightly.

The fact is that the stock market in no country can be expected to provide liquidity to the extraordinarily large blocks of equityholdings. The transfer of such large blocks, if it is to be effected, requires special mechanisms. In the case of institutions desiring to unload a big holding, it has to be done gradually in relatively small lots over a prolonged period.

The question of liquidity must be considered in relation to the commonly-held sizes of equityholdings, and not in relation to the holdings of exceptional size.

Forward Trading in Shares

Although, in theory, competition between professionals is supposed to lead to an evaluation of securities on the basis of their intrinsic long-term merits, in practice the system of speculation based on short-term expectations in prices, instead of providing a corrective to erratic movements, tends to accentuate them. The short-term speculation subordinates informed

[1]Bombay Stock Exchange, *Profile of Stock Exchange Activity in India*, Bombay, 1970, p. 37.

analysis of a company's prospects to a forecast of the behaviour of other participants in the market. The point has long been recognised. If small investors are liable to get panicky, the professional speculators have been found to suffer from even more severe fits of nervousness than the investors generally. We cannot, therefore, rely on the speculators to provide the required corrective to the psychology of the investors.

Two important conclusions emerge from the above analysis: first, the normal expectation of a genuine investor about the liquidity of his equity investments is not that of 'instant' convertibility into cash but that of convertibility within, say, 2-4 weeks; and second, from the viewpoint of the vast majority of equityholders, liquidity is needed only in moderate amounts and not in unlimited amounts.

We shall now show that the liquidity provided by forward trading in shares is lop-sided, in most cases superfluous, and, to a large extent, spurious. We shall take these points one by one.

Liquidity created by forward trading is lop-sided: The lop-sidedness in question is indicated by the fact that the trading pattern on our stock exchanges exhibited an extreme degree of concentration in a handful of securities. This concentration was the result of the system of forward trading.

Shares listed on the Indian Stock Exchanges are divided into two categories, viz., (i) the cleared list and (ii) the non-cleared (or cash) list. Only shares included in the cleared list enjoyed the facility of forward trading before it was banned in 1969. Transactions in the non-cleared shares take the form of contracts for spot delivery which means that the shares are delivered and the price for them paid generally on the next day of the transaction.

Forward transactions are contracts for future delivery. The Indian Stock Exchanges had a system of fortnightly settlement periods for forward transactions. All forward transactions during a particular fortnight were settled, through a system of clearing, on the settlement day at the end of the period in question. The system also provided a facility to operators to 'carry forward' the outstandings from one settlement to another for an indefinite period.

Basically, the facility of forward trading amounted, in a

sense, to a special kind of credit facility whereby the professional speculators could engage in buying and selling vast quantities of forward-listed securities without being required to pay the price or deliver the securities till the settlement date. The operators could enter into off-setting transactions before the settlement date so that ultimately only differences in price had to be paid for.

The system placed all non-cleared securities at a definite and significant disadvantage from the viewpoint of speculative interest because no comparable kind of credit facilities were available to professional participants for trading in these securities. Hence, a natural result of the system of forward trading was that speculative interest was, more or less, confined to a small number of securities on the cleared list.

The available data[2] suggest that, for the three years 1966-68, about 97-98 per cent of the annual trading volume on the Indian Stock Exchanges was accounted for by cleared securities alone which formed just about one-third of all listed equities in terms of market value. Thus, the share of non-cleared securities in the total trading volume was only 2-3 per cent even though they represented about two-thirds of the aggregate market value of all listed equities.

Shares included in the cleared list are those which would even otherwise have shown considerable market continuity and liquidity. Forward trading facility, which is limited to cleared securities, does not, therefore, help to create liquidity where it is most wanted; instead, it creates additional liquidity where it is already high. It seems to decree: 'He who has shall have more.'

An important cause of imperfection of the capital market everywhere has been the easier access enjoyed by the large firm to the sources of capital. The system of forward trading tends to enhance the advantage enjoyed by the large firm and, as a result, to make the securities market even less perfect

[2]See U.L. Gupta, 'Speculation at the Indian Stock Exchanges', *Business Analyst*, September-December 1969, pp. 241-42. These data are in terms of the number of shares traded rather than in terms of market values. Since both the nominal and the market values of shares of different companies range widely, the numbers can give us no more than a rough indication only.

from the viewpoint of its allocational efficiency.

Liquidity created by forward trading is superfluous in many cases: The question whether the liquidity resulting from speculative trading is superfluous or not can be answered only if we have a concept of the right amount of liquidity.

There will often arise some market 'friction' because only by chance will the buying and selling orders from investors exactly match each other at a particular moment of time. It is to take care of this 'friction' and to facilitate a more smooth functioning of the market that the intervention of the professional speculator is needed.

The relevant question that may be posed here is: To what extent should the normal transfers of equities from one investor to another be supplemented by the activity of the speculators?

The speculator's help is needed only to the extent that the buy and sell orders emanating from investors fail to match exactly at each point of time. The statistical chance of the buy and sell orders matching each other at any point of time increases as the number of holders of an individual security increases. Hence from the point of view of promoting greater efficiency over the stock market as a whole, the smaller an issue, the greater will be the need for speculative intervention to keep the market in balance and ensure continuity. If the number of transactions between investors is large enough to produce a continuous stream over a year, the activity of the professional speculators need not be a large multiple of the volume of transfers between investors.

In this connection, it should also be borne in mind that the greater the ratio of speculative business to genuine investment business, the more dominant becomes the influence of short-run speculative considerations, as opposed to long-run investment merits. It is, therefore, desirable to keep speculative business to the minimum consistent with market requirements.

An idea of the relative volume of speculative trading in particular shares can be had by comparing the total trading volume in a company's equity shares as per stock exchange records with (i) the company's equity capital and with (ii) the volume of transfers between investors as roughly indicated by the transfers registered with each company during the same period. Such an analysis was carried out by us in respect of

47 shares on the forward trading list of Indian Stock Exchanges.[3] In two of the 47 cases, the trading volume was over 100 times the volume of transfers registered with the respective companies; in 9 other cases it was over 20 times, in 6 cases between 10-20 times and in 7 cases between 5-10 times. In all these 24 cases, forming about one half of the cases examined, the liquidity created by forward trading may be regarded as superfluous—in the case of some it seems to approach astronomical proportions. In one of the 47 cases, the total trading volume was large enough to turn over the company's entire equity capital almost 15 times during the year; in 9 other cases over 2 times, and in 3 other cases more than once. How much more it is than what is needed can be judged from the fact that the percentage of equity capital changing hands between investors, as evidenced by transfers registered with companies, is below 8 per cent in the vast majority of companies.[4]

The liquidity created by forward trading is to a large extent spurious: The reason why we regard the liquidity resulting forward trading as 'spurious' is that most of these professional operators are interested only in trading in price variations and not in acquiring the securities by paying for them or giving actual delivery of securities, as the case may be. To illustrate, if an investor wants to sell off his holding, he needs to find a person, as quickly as possible, who would take delivery of securities from him and pay him immediate cash. The existence of speculators interested only in margin trading will not help this investor. The business created by speculators' activity is very largely of a wholly fictitious character. This was the reason why the outstandings of forward business existing at the time of imposing the ban on forward trading could not be squared for months.

General Conclusion

We recognise the need for a limited amount of professional speculation from the viewpoint of a smooth functioning of the

[3]For details, see *Economic and Political Weekly*, Vol. VIII. No. 34, Review of Management, August 25, 1973, pp. 85-96.

[4]Ibid.

stock markets in the interests of the genuine investors. The system of forward trading in shares as it prevailed before 1969, as also the modified system introduced by some exchanges after the imposition of the ban of 1969, is in our opinion completely useless from the viewpoint of the genuine investor. It is only a trading in differences, and not a genuine kind of trading. The kind of liquidity which it creates helps the speculator, not the investor. What is needed is a more genuine kind of professional trading in securities over the whole range of listed securities.

In our opinion, the distinction between cleared and non-cleared securities should be totally abolished. The present clearing system does not encourage genuine trade of the kind needed to provide liquidity to investors; it tends to degenerate into gambling in price variations only. In view of this, we must really think of a new kind of professional speculator, who would function as jobber engaged in genuine buying and selling operations over a wide range of securities and who may be assisted, not by the disguised form of credit facility created by the system of forward trading, but by direct credit facilities, granted by banks against composite portfolios of securities so that the speculative operations really assist the largest possible number of investors.

The mechanism of the stock market is in need of structural reforms if its performance, as an economic institution, is to reach an acceptable standard in the conditions of today. Long back, Keynes had pointed out 'the extreme precariousness of the basis of knowledge on which our estimates of prospective yield have to be made' and deplored the influence of the stock exchange in accentuating this precariousness.[5] The stock market is traditionally in a state of either euphoria or despondency, passing quickly from one to the other. This has a destabilising effect on private industrial investment. The fundamental cause of this instability is the predominance of speculative influences over the influence of genuine investment considerations.

The aim of reforming the organisation and functioning of the stock market should be 'to make stock exchanges market

[5] J.M. Keynes, *The General Theory of Employment, Interest and Money*, London, 1936, pp. 149-61.

places for investors and not places of resort for those who would speculate or gamble'.[6] Already, the role of stock exchanges in our financial system has been greatly reduced over the past 15 years. Unless the stock exchanges can justify their existence by their contribution to the public welfare, this declining trend cannot be arrested. They cannot be allowed to promote the interests of their members at the expense of the investors and the society.

We need a great deal more research into the working of stock exchanges in order to improve our understanding of the problems. Unfortunately, neither the stock exchanges nor the governmental regulatory authorities in India, have shown much urgency in this matter. The result is that governmental regulation of stock market operation remains a 'hit or miss' affair and the public image of stock exchanges remains as bad as ever.

[6]Cited by Securities and Exchange Commission, *Report of Special Study of Securities Markets*, Washington, 1963, Part 2, Chapter 6, p. 35.

22

Trends in Corporate Financing in India, 1851-1900*

Radhe Shyam Rungta

This paper gives the early historical background of company financing and share markets in India. Share trading in India began about 125 years ago, in an unorganised and unregulated form. Rungta gives an account of the origins of the Bombay and Calcutta Stock Exchanges and describes the vicissitudes through which the Indian stock exchanges have passed.

Editor

The experience of industrial entrepreneurs with joint companies between 1850 and 1870 significantly changed their ideas about the capital structure of a company, that is, about a proper nominal value of ordinary shares, the methods of raising loan capital, and its relationship with the equity capital.

With the passage of time, the number of corporations increased greatly. The promoters of new companies were obliged, therefore, to reach a wider public in an effort to raise capital. The public had, in the meantime, become better acquainted with the workings of companies and their willingness to invest in them naturally increased. Thus the class of investing

*Taken from R.S. Rungta, *Rise of Business Corporations in India*, Cambridge University Press, Cambridge, 1970, pp. 203-11. Reprinted by Permission.

public widened gradually, bringing into its fold many whose means were definitely limited.

In the fifties and the sixties it was quite usual to have shares of the denomination of Rs. 5,000 and Rs. 2,500, as they were generally taken up by wealthy merchants or occasionally by the rulers of Indian states and rich landlords. But as the demand for capital grew and the social composition of the investors changed, the shares of high face value became difficult to negotiate. It was said that the reason why the shares of the Royal Cotton Mills of Bombay were selling at a discount of Rs. 400 to Rs. 500 in 1873 was that the high face value of these shares made it difficult for many people to invest in them.[1] It was realised that the unit value of the share needed to be drastically reduced but there were some legal difficulties in doing so. Strictly speaking, the face value of the shares could not be legally reduced without first going into voluntary liquidation,[2] and this was the course that the Great Eastern Spinning and Weaving Co. Ltd. had decided to take.[3] But there seems to have been some confusion about the correct interpretation of the law on this point. The Colaba Spinning and Weaving Co. Ltd.,[4] and the India General Steam Navigation Co. Ltd.,[5] for instance, did not observe the legal niceties while

[1]T.O.I. [Times of India], 28 April 1873.

[2]Section XII of the *Act of 1866* reads as follows:
'Any Company limited by shares may so far modify the conditions contained in its memorandum of association, if authorised to do so by its regulations as originally framed, or as altered by Special Resolution in manner hereafter mentioned, as to increase its capital, by the issue of new shares of such amount as it thinks expedient, or to consolidate and divide its capital *into shares of larger amount than its existing shares*, or to convert its paid-up shares into stock, but, save as aforesaid, and save as hereinafter provided in the case of a change of name, no alteration shall be made by any company in the conditions contained in its memorandum of association.'

[3]T.O.I., 28 April 1873.

[4]Ibid., 1 August 1874.

[5]In 1881 the company changed the nominal value of its shares from Rs. 1,000 each to Rs. 100 each. 'It was considered that the larger sum was too unwieldy for the local market, other companies consisting almost wholly of Rs. 100 shares, and to have retained the unit of Rs. 1,000 would have handicapped dealings and made the scrip issue less accessible to small investors'. Brame, p. 132.

changing their share value. Thus in the seventies and eighties, and even more in the years following, shares of the value of Rs. 1,000, Rs. 500, Rs. 250 and Rs. 100 were issued. An exceptional and extreme step in this direction was taken in 1890 when the Calcutta market was seized with a craze for gold mining; all the three dozen or so companies floated in that period issued only one rupee shares. A gradual reduction in the nominal value of shares was certainly a correct move. The issue of one rupee shares was, however, no more than a device to attract the poor and ignorant.

Hitherto,[6] the practice had been to raise the great bulk of the working capital by private borrowing from local banks and shroffs against the hypothecation of the stores, and by mortgaging the fixed assets of the company. Loans arranged in this way had the disadvantages, first, of being relatively costly in terms of interest rates and secondly, of being subject to greater pressure from the individual lenders for repayment in times of monetary stringency or whenever the company ran into difficulties. From the company's point of view this aggravated its difficulties still further and caused much embarrassment which led, at times, to foreclosures of mortgage on its properties and its liquidation.[7]

A loan had, therefore, come to be regarded in the seventies as a curse and a parasite which sucks the life-blood out of a cotton or jute mill. This was certainly a very poor way of meeting the deficiency of equity capital. Press criticism enlightened the shareholders and a change followed. Both preference shares and debentures were used to replace private borrowing but only debentures can be said to have acquired a

[6]See p. 235.

[7]Reviewing the reasons for the crisis in the cotton mill industry, James Greaves of Greaves Cotton & Co., said: 'Another cause which has been making itself felt, is the insufficiency of the share capital invested in these undertakings. Borrowed capital is all well in its place, and in prosperous times is a great advantage to the shareholders, but if adversity comes, the loans are called in and have to be replaced at heavy rates of interest, which I need hardly add militates against the successful working of the mills and very often leads to embarrassment.' T.O.I., April 1879. See also: T.O.I., 8 December 1879; 31 May 1881; 29 April 1878; and 17 February 1879.

certain popularity in the remaining years of the century.[8] Criticisms in the press, particularly in periods of depression when dividends either disappeared or were declared out of capital, also did a great deal to change the concepts of the management about a proper policy towards depreciation, dividends and reserves. Almost to the end of the seventies, depreciation as an item in the profit and loss account was ignored, stocks were overvalued and dividends fluctuated. In Bombay the lead for a change of methods was given, once again, by the firm of Greaves, Cotton & Company. The mills under their management followed a consistent policy of building up a dividend equalisation reserve and declaring a steady 10% in dividends.[9] On the other hand, J.N. Tata seems to have been the first to declare his support for a policy of sufficient depreciation allowance before arriving at the net profit figure.[10] In Calcutta the change of heart began about the year 1879, after the unreserved criticisms by the *Friend of India*,[11] and it was not long afterwards that the policy of providing for depreciation became general. General reserves were also started by some companies to finance expansion and in some cases these were later capitalised by the issue of bonus shares.[12] This must have been a particularly difficult task for the management to achieve, as the pressure from the shareholders for large dividends was great, and this probably accounts in part, at least, for the reluctance of the management to build up reserves.

Another interesting experiment in the technique of financial management was the issue of bearer dividend warrants. This was obviously introduced for the purpose of facilitating the use of an already widely used practice of blank transfer shares.[13] The only thing the registered shareholder had to do now was to send the bearer warrant to the holder of the blank transfer.

[8]See a list of debentures issued in Calcutta in T.O.I., 30 May 1880 and share market quotations in any issue of the F.O.I. [*Friend of India*] or the *Englishman* in 1900.

[9]T.O.I., 4 January 1884.

[10]Ibid., 17 August 1886.

[11]Various Issues. See, for instance, 24 March 1880; 28 November 1881; 9 November 1877; 28 September 1877.

[12]T.O.I., 28 March 1882 (on the Empress Mill)

[13]T.O.I., 18 October 1890.

Dealings in government securities and shares of such companies as then existed were a feature of business life in Calcutta and Bombay long before 1850. Business in these instruments of finance had become particularly important in the early sixties as a result of the speculative boom in those years. The enthusiasm generated by the boom in Calcutta was such that the European bill and share brokers of the city thought it fit to organise a stock exchange. There is a reference in the *Thacker's Bengal Directory* of 1864 to a 'Stock Exchange' at 11, Strand, in Calcutta. Out of the thirty-six Europeans listed as bill and share brokers, fourteen were named as the members of this Stock Exchange. The only other information recorded about this institution was that 'a room, where leading foreign and local papers, together with the latest telegraphic despatches, were available was open to the subscribers paying Rs. 5 a month'.[14] It is doubtful if this institution ever achieved anything more than providing a meeting-place and an information service.

There was, however, in existence another institution in Calcutta which was founded on 1 June 1858 at 1, Clive Row. This was a mercantile exchange and had a managing committee of nine persons, one of whom, Ramgopal Ghose, was an Indian.[15] In 1867 its offices were removed to 102, Clive Street where they remained until, in 1893, they were again shifted to the Royal Exchange Buildings. Although the institution had been variously described before 1867 as 'The Exchange' or 'The Merchants' Exchange', during the rest of the century it was always designated as 'The Brokers' Exchange.'[16] *The Friend of India* headed its share market quotations as the 'Official Quotation' and they were supplied by the 'Brokers' Exchange.[17] The management committee of the Brokers' Exchange met regularly on the first Saturday of every month. Unfortunately, our researches have not revealed any further information about this institution, though it would seem to have been an attempt to organise the share market in Calcutta.

[14] *Thacker's Bengal Directory for 1864*, p. 85.
[15] Ibid.
[16] Ibid., for 1868.
[17] See any stock market report in 1876, 1877 and 1878.

In the sixties the Indian element in the share bazaar in Calcutta was not large, whilst the Brokers' Exchange was a purely European organisation both in its membership and management. The business of dealings in shares and other securities was done under a Neem tree, where all the brokers met. When the Bengal Chamber of Commerce acquired in 1893 the buildings of the Oriental Bank and renovated and renamed them the Royal Exchange Buildings, an attempt was made to remove the share bazaar from under the Neem tree to this building, but the admission of Indians, particularly of the Marwaris, who had by now become the mainstay of the share market, led to some controversy as they were regarded as 'noisy'. It was, however, admitted that without their presence it would be useless to think of any shift in location. To resolve the dilemma, a suggestion was put forward that a partition wall might be built in the proposed hall. Nothing, however, seems to have come out of this proposal and the share market remained under the Neem tree until, in 1908, the Calcutta Stock Exchange was formally constituted.[18]

[18]The following books on Indian capital market, industrial financing and the development of stock exchanges may be usefully consulted:

S.K. Basu—*Industrial Finance in India*, 1939.

K.L. Garg—*Stock Exchanges in India*, 1946.

M.A. Mulky—*New Capital Issues Market in India*, 1947.

P.C. Jain—*Industrial Finance in India*, (1961?).

R.C. Mehta—*Capital Market in India for Planned Growth*, 1965.

Stock Exchange [London] Official Year Book.

Calcutta Stock Exchange Official Year Book, 2 volumes, 1940–42.

Madras Stock Exchange Official Year Book.

Investor's India Year Book, compiled by Place, Siddons and Gough, 1st Issue, 1912.

Navaroji Jamshedji Bulsara, *Guide to Indian Securities, Stocks and Currency Notes*, 1897.

A Manchester Man, *A Guide to Indian Investments*, 1861.

N. Das, *Industrial Enterprise in India*, 1938.

A. Krishnaswami, *Capital Development in India*, 1860–1913, (typescript), 1941.

I.M.F., *Financial Institutions of India*, 1950.

K.K. Sharma, *The Indian Money Market*, 1934.

V.R. Cirvante, *The Indian Capital Market*, 1956.

P.S. Lokanathan, *Industrial Organisation in India*, 1935.

M.M. Mehta, *Structure of Indian Industries*, 1955.

Business in the share market in the nineteenth century, it would seem, was conducted by established customs of the city rather than any formal rules, for, as late as 1927 the *Indian Year Book* reported that 'there are no settlement days, delivery is due the second day after the contract is passed, and sal s of securities are effected for the most part under blank transfer'.[19] But, without further research, one cannot feel certain that there was no formal element at all in the rules which governed the transactions of the share market. The fact that the committee of the Brokers' Exchange met once every month throws doubt on the matter. One wonders what was the purpose of this meeting so regularly held. Dealers in the stock market acted as brokers as well as dealers. Transactions were made both for ready delivery and future delivery. Contracts for future delivery were known as 'time bargains'. There was also a fairly large business in the 'margins' on borrowed money.[20]

In Bombay, on the other hand, Indians were dominant from the very beginning in the business of stocks and shares. Between 1840-50, it is said, there were no more than six share brokers in Bombay who were recognised by the banks and the merchants.[21] In 1860 the number had increased to sixty. The brokers were led by Premchand Roychand 'who gave to the stock and share brokers a standing and importance not hitherto achieved'.[22] The outbreak of the American Civil War, and the boom that followed, increased the number and popularity of the brokers on an unprecedented scale. At the height of the boom there were as many as 200 to 250 brokers in Bombay.[23] The crash on the cessation of the Civil War, however, brought in

M.V. Namjoshi, *The Development of the Large-Scale Private Sector in India* (Thesis), Gokhale Institute of Politics and Economics, Poona, 1956.

D.R. Samant and M.A. Mulky, *Organisation and Finance of Industries in India*, 1937.

National Council of Applied Economic Research, *Capital Market in a Planned Economy*, 1966.

[19] A.K. Sur (Ed.): *The Stock Exchange—A Symposium*, 1958, p. 62.

[20] See Commercial Affairs in Bengal, T.O.I., 28 December 1874.

[21] *Report of the Bombay Stock Exchange Enquiry Committee*, 1924, pp. 3-6.

[22] Ibid.

[23] Ibid.

its train widespread failures and the resulting disillusionment naturally decreased both the popularity and the number of the share brokers in Bombay. The real basis for the sustained growth of the share market activities was provided by the expansion of the cotton mill industry in the early seventies. In 1877 the number of share brokers had increased to 318 and for the remaining years of the nineteenth century it remained in that neighbourhood.[24]

Originally the brokers used to meet on the Cotton Green where the Elphinstone Circle is now situated and they continued to meet at this place until 1855. Afterwards, for a time, they met between the old Fort walls and the old Mercantile Bank. Finally, they found a place in Dalal Street and began to assemble there.[25] Here, for the rest of the century, the brokers met and moved about hectically in sweltering heat and rain, much to the annoyance of the passers-by; moreover, they remained liable to be removed by the police for causing obstruction to the pedestrians.[26] After the brokers had organised themselves in 1875, they, together with the leading mill-owners of Bombay, endeavoured to house the share bazaar in a suitable buildin.. To this end, D.M.Petit donated twenty-three shares of Victoria Mill which, together with other government securities and cash given by him, amounted to Rs. 25,000.[27] The brokers themselves collected Rs. 7,000.[28] At the end of the year 1887 the Native Share and Stock Brokers Association had some 38,000 rupees invested in the Petit Mills at 6% per annum.[29] It was then suggested that the Association should issue debentures to make up the deficiency to acquire a building, but the idea does not seem to have gained favour.[30] Three years later the funds of the Association reached a figure of Rs. 50,000 and a European gentleman was appointed as the *ex-officio* member to take steps toward erecting a proper hall.[31] It was not until 1899,

[24]Ibid.
[25]Ibid.
[26]T.O.I., 11 January 1889.
[27]Ibid., 7 January 1887.
[28]Ibid., 6 January 1888.
[29]Ibid.
[30]Ibid.
[31]Ibid.

however, that a special hall for the Stock Exchange was actually acquired.[32]

The movement to organise and regulate the business in stocks and shares gained strength in Bombay after the shattering experiences of the crash that followed the share mania of 1863-65. The frequent resort to excessive and unhealthy speculation and the use of undesirable practices in pursuance of private gain by the unscrupulous elements among the brokers, whose later bankruptcies left many in complete destitution, stimulated a demand for bringing some order and cohesion to the 'chaotic' Dalal Street. On 10 July 1875 the *Times of India* reported a meeting of the brokers held for the purpose of restricting dealings in 'differences'. On the 11th the brokers had set up a committe to draft rules for the Native Share and Stock Brokers Association which they had founded only two days before, with the object of protecting 'the character, status and interest of native share and stock brokers and for providing a hall or building for the use of the members of the Association.'[33] In fact, a little earlier than the founding of this Association, a joint stock company was promoted to provide an 'Open Stock Exchange', but the scheme did not find any favour in Bombay and was dropped.[34] Twelve years after the Native Share and Stock Brokers Association had been founded it was formally constituted by an indenture dated 3 December 1887.[35]

The aims of the Association, as contained in its Articles, were, among other things, 'to promote honourable practice; to suppress malpractices; to settle disputes among brokers; to decide all questions of usage and courtesy in conducting brokerage business'.[36] None but the natives of India were eligible for the membership of the Association and the admission fee as originally fixed was Rs. 51 only.[37] By this time, it seems, the Association was not being properly managed, as the *Times of India* wrote that 'the present Stock Exchange, as it is, is imperfect in its constitution, and has for its members, with a

[32] *Report of the Bombay Stock Exchange*, etc., p.4
[33] T.O.I., 16 July 1875.
[34] T.O.I., 23 October 1874.
[35] *Report of the Bombay Stock Exchange*, etc., p.3.
[36] Ibid., p. 4.
[37] Ibid.

few honourable exceptions, a set of disorderly and unprincipled persons.[38] Yet, after the near-crisis situation on 24 October 1888, created by the failure of some brokers who had been making heavy forward purchases for over two years in certain mill shares and were embarrassed by the enforced closing of accounts, the same paper reported that "the defaulters had been put out of the Stock Exchange" and that the management had taken stringent measures to prevent a recurrence of the event in the future. Nonetheless, the paper opined that the Board needed a change for the better and the rules of the Association also required a good deal of tightening up. The most important thing, it emphasised, was the provision of a good guarantee by the members of the Association.[39] Despite these criticisms the Association seems to have been gaining steadily in strength. By 1890 the 'Exchange Banks' in the city had recognised the Association and they did their business with only such persons as were approved by the directors of the 'Stock Exchange'.[40]

The growth of stock exchanges can be said to be a function of the growth of companies. The increase in the number of companies in its turn brings about an increase in the number of brokers to cope with the increased volume of share market business. When all and sundry start dealing in securities the standard of performance, in the absence of regulatory measures, naturally falls. It is at this stage that serious-minded people who honestly depend for their income on the share market begin to take measures to secure the confidence of the investing public, to organise the share bazaar into a stock exchange which will enforce and guarantee a minimum standard of performance from its members on which the public will be able to depend. About the middle of the seventies Bombay and Calcutta had reached such a stage of development. This is further evidenced by the fact that though the brokers in Bombay had got together and taken concerted action to deal with an emergency situation almost a decade earlier, it was not thought necessary to organise the market until a real and

[38]T.O.I., 7 January 1887.
[39]Ibid., 4 January 1899.
[40]Ibid., 3 January 1891.

substantial increase had taken place in the number of companies.

At this stage it would be convenient to look at some of the peculiarities of the share markets in Bombay and Calcutta. In both places the share market operations were characterised by a large amount of speculative business. This was probably due to the presence of a large number of Marwaris who are generally regarded as being, by instinct, more speculative than others. The system of time bargains and absence of compulsory settlement days helped to develop and maintain this bias in the markets. Dealings in differences on borrowed money are a sure sign of speculation as well as disaster. This was clearly evident from the occasional crisis that the failure of the brokers, known already to be weak could bring about.[41] Moreover, twice at least each year, particularly in Calcutta when the share market was closed for long periods on account of Puja and Christmas holidays, the speculators had to make forced sales as they were obliged to return the borrowed money. On these occasions shrewd people looked around for cheap bargains. False rumours were frequently resorted to as a means of making quick profits. The brokers waited eargerly for *Bilayat Ka Tar* or the telegram from London and the markets were sensitive to the news of war and peace. It must also be admitted that the brokers and dealers in shares in Bombay and Calcutta were very shrewd people—well versed in the art, the techniques, and the subtleties of stock market operations. One of their boasts was that they could teach a trick or two to even those on the London Stock Exchange in the art of making 'put' and 'call' options.[42]

[41]Ibid.
[42]T.O.I., 4 January 1869.

23

The Development and Organization of the New Issues Market*

L.C. Gupta

This paper traces the emergence of an organised new issue market in India as a result of the development of institutional underwriting. Significant differences in the roles and policies of the various underwriting institutions are also noted.

Editor

This chapter is concerned with the organization for the marketing of new issues of industrial securities in India. Section 1 below describes in general terms the functional and organizational structure of the new issues market. Section 2 is concerned with a discussion of the evolution and present institutional set-up of the underwriting organization in India. Section 3 attempts to measure the growth of underwriting practice and the relative contributions of the various underwriting institutions. The final section contains the concluding observations.

(1) FUNCTIONS AND ORGANIZATION OF THE NEW ISSUES MARKET

The essential function of a new issues market is to

*Taken from L.C. Gupta, *The Changing Structure of Industrial Financing in India*, Oxford: Clarendon Press, 1969, pp. 119-39,

facilitate the transfer of investible funds from their owners to entrepreneurs seeking to establish new enterprises or to expand existing ones. Such facilities are indispensable in any economy in which saving and real investment are not necessarily undertaken by the same individuals.[1]

The efficiency of the market depends primarily on its ability to guide the flow of available investible funds into economically the most productive investment.[2] This view of the market's function conceives the market mechanism essentially as an allocative mechanism, allocating a given volume of investible resources among firms and industries. The market arrangements, however, also influence directly as well as indirectly, the volume of resources made available to industry. The capacity of the market machinery to reach down to all potential investors, and the type of savings and investing institutions existing in a capital market have a direct bearing on the volume of available savings that may be channelled into industry.

Although organizationally the new issues market is distinct from the market for old securities, it is important to recognize that, economically, both old and new securities are integral parts of a single market. The two parts of the market are susceptible to common influence, and also act and react upon one another. That is why price movements on the stock exchange (the market for existing securities) and the volume of activity on the new issues market are directly and

[1]The new issues market, however, should not be conceived as exclusively serving the purpose of raising finance for new capital expenditure; the organization and facilities of the market are also utilized for selling existing concerns to the public, as going concerns (through conversion of existing unincorporated enterprises, or of private companies into public companies). This kind of public issue was so typical of new issues in the U.K. during the inter-war period that Mr. A.T.K. Grant in *A Study of the Capital Market in Post-war Britain* (1937) remarked that 'the new issue market is nothing more than a system by which going concerns are sold to the public or developed with the aid of public money' (p. 132). This is, however, not quite true of the present phase of the new issues market in India where entirely new enterprises account for a sizeable part of the total volume of new issues.

[2]For a penetrating discussion of the theoretical and practical problems involved, see R.F. Henderson, *The New Issue Market and the Finance of Industry*, (Cambridge, 1951), Ch. 1.

closely related: new issues tend to increase when stock prices are rising, and tend to decrease when stock prices are declining. The stock exchanges are usually the first to feel the impact of a change in economic outlook, but the effect is quickly transmitted to the new issues section of the market. Apart from the extreme sensitivity of stock exchanges to changes in the economic climate, the quantitative predominance of old securities in the market usually ensures that it is these which set the tone of the market as a whole, and govern the prices and acceptability of new securities. Thus the flow of new savings into new securities is profoundly influenced by conditions prevailing in the old securities market.[3]

The general function of the new issues market, viz., the channelling of investible funds into industrial enterprises, has been split from an operational standpoint into three distinct services: (1) origination, that is, investigation and processing of proposals for new issues; (2) underwriting of new issues; and (3) distribution of new securities to ultimate investors. A developed new issues market is characterized by the presence of specialized agencies to perform each of these three services.

Although the same institution may sometimes perform all the three services mentioned above, each service is quite distinct from the other, and is usually paid for separately in some way both in the U.S.A. and the U.K. Institutions which specialize in origination usually combine the function of underwriting. Normally, they underwrite only a part of the issue themselves, the rest being underwritten or sub-underwritten by institutions which specialize in distribution work, such as stockbrokers or security dealers, or by institutional investors, such as insurance companies, pension funds, and investment trusts. Some institutions may perform only one function; say, distribution; others may combine two of them, such as origination with underwriting, or underwriting with distribution; while a few may engage in all the three.

The emergence of specialist firms to assist new issues

[3]The securities market represents an important case where the stock-demand-and-supply curves, as distinguished from flow-demand-and-supply curves, exert a dominant influence on price determination. See Nicholas Kaldor, *Essays on Economic Stability and Growth*, London, 1961, p. 3.

depends, of course, on the volume and continuity of new issue business. Specialization is very much a function of growth.[4]

Even in industrially advanced countries, however, specialization in the new issue business has rarely been pushed so far as to result in full-time concentration by certain firms on new issue business alone. The new issue business is inherently very unstable and even discontinuous. Partly, therefore, to give greater stability to firms engaged in this business, and partly on account of other practical considerations, new issue business is usually combined with other types of financial business. Specialization in new issue business means, therefore, in practice, that certain firms concentrate more particularly on this business and have developed a sort of expertise in it.

While the nature of the services provided by an organized new issues market is the same in all developed countries, the degree of development and specialization of market organization, the type of institutions found, and the actual procedures followed differ from country to country, as they are determined partly by history, and partly by the particular legal, social, political, and economic environment.

(2) THE EVOLUTION AND INSTITUTIONAL SET-UP OF THE UNDERWRITING ORGANIZATION IN INDIA

The presence of originating institutions enjoying high reputation and confidence is of crucial importance for the efficient operation of a new issues market. This is precisely what was lacking in India before 1955. New issues in India were occasionally underwritten even before the Second World War, but such underwriting was mostly in the nature of either share-pushing or stagging, because it was done either by *ad hoc* groups composed of interested persons or by stockbrokers and

[4]See, in this connection, the remarks on the growth of private banking by J.S.G. Wilson: 'Thus private banking was at first merely a side-line of business in less liquid chattels. The early "bankers" were merchants, or goldsmiths, or sometimes manufacturers. Only when their banking business grew to such proportions as to make it impossible to combine conveniently these two sets of activities, did the choice have to be made and the banker was obliged to become a specialist.' 'The Structure of Money Markets', *Banca Nazionale Del Lavoro Quarterly Review*, March 1961, p. 69.

individual financiers simply to take advantage of boom conditions. During the hectic years of the post-war boom, underwriting became more frequent. Most of it was done without regard to the real merits of the proposals. It was not, therefore, a healthy development.

The lack of independent and reputable originating institutions constituted the central organizational weakness of the new issues market in India. The following observations of the Macmillan Committee about the machinery of new issues in the U.K. before the 'thirties apply with equal force to the conditions prevailing in India up to the mid 'fifties:

> We believe that our financial machinery is definitely weak in that it fails to give clear guidance to the investor when appeals are made to him on behalf of home industry....
> It would in our opinion be an important reform that relation between finance and industry should be so developed that issuing institutions of first class strength and repute should vouch to the investor more normally and more fully for the intrinsic soundness of the issues made....
> In this way, the investor would be encouraged to support well-vouched issues and be put on his guard against others.[5]

The system of issuing securities to the public, without the independent check provided by reputable intermediary institutions was open to serious abuse on the part of promoters. In fact, the lack of originating or issuing houses, combined with the many deficiencies of law relating to company formation and management, provided ideal conditions for the unscrupulous company promoters to thrive. Cases of downright fraud were common, especially during boom periods; for the investing public had no means of distinguishing genuinely sound issues from bad and fraudulent ones. Each boom was invariably followed by a complete and ruinous collapse of the market for long periods, during which it was impossible to float practically any new enterprise. To attract public subscription to new securities even of genuinely sound enterprises was extremely difficult in normal times, except in the case of concerns

[5] U.K., *Report of the Committee on Finance and Industry*, popularly known as the Macmillan Committee (London, 1931), paras. 387-88.

promoted by the best-known business houses, usually British. This was one of the important factors tending to increase the concentration of industry under a few well-known managing agency houses.

Beginning from scratch in 1955, a strong underwriting organization has gradually been built up, completely changing the face of the new issues market in India. The process began with the setting up, in January 1955, of the Industrial Credit and Investment Corporation of India Limited (ICICI) with the primary objective of providing underwriting facilities for new issues. For some time, the ICICI had to operate in this field almost single-handed. It gradually became the focal point around which a more broad-based underwriting organization began to take shape. There already existed in India some institutions which could play a supporting role in the underwriting system, such as stockbrokers, banks, and other financial bodies. These institutions were gradually drawn into the orbit of the underwriting organization in increasing numbers. Stimulated by the example of the ICICI, the Industrial Finance Corporation of India (IFC) also began to extend its activities to underwriting of new issues in 1957.

In 1956, the Government of India nationalized the life insurance business and formed the Life Insurance Corporation of India (LIC). By virtue of the concentration of funds resulting from its formation, it began to play a progressively more important role in the new issues market. It is now one of the pillars of strength of the underwriting organization.[6]

Two more important institutions were added to the underwriting organization in 1964, viz., the Industrial Development Bank of India (IDBI) and the Unit Trust of India (UTI).

Thus, within a decade, beginning from 1955, an

[6]Life insurance companies in India, before nationalization, did not play any significant role in underwriting new industrial issues. The Oriental Government Security Life Assurance Co. Ltd., the largest of them all, did not engage in this business at all. Others underwrote capital issues in exceptional cases only. Most of them were individually small. The Shroff Committee, appointed by the Reserve Bank of India in 1953, recommended their active participation in underwriting by formation of an underwriting consortium together with the commercial banks. No action, however, was taken to implement this recommendation.

institutional machinery of considerable strength has been created for the underwriting of new issues in India.

There are important differences among underwriters in general approach and the policies and standards followed by them. For this very reason, each class of underwriters has a different significance. From this point of view, underwriters of new issues in India may be said to fall into six distinct groups.

(1) *Special Institutions*

The special institutions which are actively engaged in the underwriting business are the ICICI, the IFC, and the recently created IDBI. Regional institutions set up by state governments have occasionally participated in underwriting, but are not of much importance, with the exception of the Madras Industrial Investment Corporation Limited.

The approach of the special institutions to underwriting proposals is entirely objective and impersonal, and places primary emphasis on the long-term viability of the enterprises concerned, rather than on the immediate saleability of the issues. Their scrutiny of an application for underwiting is as detailed as that of an application for a long-term loan. The immediate market prospect of an issue is only a secondary consideration for the special institutions. It is a noteworthy feature of the underwriting policy of special institutions that they are prepared to nurse new enterprises in their initial years by holding the securities not taken up by the public. As Mr. G.L. Mehta, the Chairman of the ICICI has stated, 'Our underwriting activity takes into account the fact that the investment market in India is often unable *initially* to fully take up capital which is publicly offered; and the object of this Corporation is to fill the gap by absorbing the unsubscribed capital'.[7]

This policy, which has become the accepted policy of all special institutions in India, was further elaborated by Mr. Mehta in a more recent statement as follows:

> In keeping with ICICI's objectives we took up such business [that is, underwriting] even when we knew that in

[7]See Chairman's Statement circulated with the *Fourth Annual Report* (1958) of the ICICI.

the conditions then prevailing, we would have to take up a substantial portion of what we underwrote as, in fact, did happen. Such underwriting was done on an analysis of the long term prospects of the company whose shares were underwritten, which we found to be favourable. The reason for undersubscription was, as mentioned above, the restricted nature of the Indian capital market as a result of the less developed investment habit of the public as well as the uncertainty about the profit-earning capacity of industrial concerns.[8]

In pursuance of this policy, both the ICICI and the IFC had to take up substantial proportions of the securities underwritten by them year after year. During the twelve years up to the end of 1966 the ICICI had completed 123 underwriting operations for Rs. 27.23 crores; of these, the majority were under-subscribed, and the ICICI was required to take up securities amounting to Rs. 15.34 crores, or about 56 per cent of the amount underwritten by it.[9] This has been the experience of the ICICI every year, including the boom years 1959–61.[10] Further, this is true of every class of security underwritten—equity shares, preference shares, and debentures.[11]

The IFC had to take up even larger proportions than the ICICI. It had completed 106 underwriting operations for Rs. 17.46 crores up to the end of June 1966. In ninety-nine of the issues, public subscription fell short of the amount offered and the IFC was called upon to take up unsubscribed securities of Rs. 14.45 crores, representing 87.6 per cent of the total amount underwritten by it.[12] One of the reasons for this high proportion seems to be that the underwriting business that usually comes to the IFC is the most difficult type; presumably because the issuing companies usually approach the IFC for

[8]See Chairman's Statement circulated with the *Eighth Annual Report* (1962) of the ICICI.

[9]See ICICI, *Twelfth Annual Report*, p. 15.

[10]In the period 1959–61, the ICICI underwrote seventeen issues for a total amount of Rs. 4.42 crores; of this, it had to take up Rs. 2.24 crores in fourteen issues. See ICICI, *Ten Years of Participation in Industrial Development* (Bombay, 1965), p. 8

[11]Ibid., pp. 8–10.

[12]See IFC, *Eighteenth Annual Report* (1965/6), p. 22.

underwriting as a last resort because of its rather bureaucratic procedures.

Leaving aside temporary market disturbances due to political and other factors, such as events since 1962, even in normal times, the demand for new industrial securities from the investing public in India seems to be highly selective, and is concentrated on issues which have a chance of immediate capital appreciation. The investing public places a high premium on issues backed by well-known names and is reluctant to provide capital to new and less-known entrepreneurial groups.[13] In contrast, it is an important feature of the policy of special institutions that they endeavour 'to make funds available wherever there are reasonable standards of competence and the purposes for which the capital is required are reasonable'.[14] Instead of seeking the large profits which can be made by following a highly selective practice, the special institutions aim to provide 'a wide general service at equitable rates'.[15]

A corollary of the policy of almost disregarding immediate market prospects has been the willingness of special institutions to underwrite at all times, good and bad. In fact, the special institutions have made particular efforts to support new issues at bad times when other underwriters tend to withdraw from the market.[16] Underwriting by special institutions has helped to

[13]Some interesting data on the pattern of public response to capital issues during 1960–62 are provided by a recent Reserve Bank study. See *RBI Bulletin*, June 1964, pp. 749–50.

[14]Evidence submitted by Lord Piercy, Chairman of the Industrial and Commercial Finance Corporation Limited (U.K.) to the Radcliffe Committee, *Memoranda of Evidence*, Vol. III, p. 196.

[15]Lord Piercy's Statement circulated with the *Nineteenth Annual Report* (1963–64) of the Industrial and Commercial Finance Corporation Limited, U.K.

[16]This policy has become particularly evident during the last four years or so, when the stock market in India has experienced extremely difficult conditions. The Government of India placed more funds at the disposal of the IFC and the ICICI to enable them to extend greater support to new issues. It has also set up the IDBI to strengthen further the machinery of special institutions. This is, however, not the first time that the special institutions, have demonstrated their keenness to extend support at difficult times. The ICICI had displayed the same attitude when markets had become depressed after the budget proposals of May 1957.

keep the flow of new issues going at all times.

The special institutions have no direct contact with potential investors. What they have is a reputation for thoroughness of investigation and independence of judgment. Their underwriting is not based on their own ability to sell the issues, but is an expression of faith in the long-term soundness of the venture. The success of their underwriting operations depends much on the support of stockbrokers, who are in direct contact with investors.

(2) *Institutional Investors*

The second important category of underwriters consists of the institutional investors. In this category, the LIC and the UTI overshadow all the rest. Both these institutions represent extraordinarily large concentrations of funds. Their interest in underwriting has been stimulated particularly by the difficulty of acquiring sufficiently large blocks of suitable securities from the market. Long-term institutional investors other than the LIC and the UTI are quantitatively not important. Among the private investment trust companies, only one is worth mentioning, viz., the Investment Corporation of India Limited set up by the House of Tatas in 1937. This company, with the reputation of Tatas behind it, has been fairly active in the underwriting field. The rest of the private investment companies are too small to be of much consequence. Some of the general insurance companies have also been interested in the underwriting of new issues in recent years.

The LIC's point of view is that of a long-term investor. The purpose of its underwriting is to purchase the securities for its portfolio. For this reason, its underwriting has sometimes been 'firm', that is, the securities underwritten by it, are agreed to be allotted to it. In any case, the LIC always applies for the full amount of the securities underwritten by it. Its underwriting policy is, therefore, governed by its investment policy and has to fit into the general framework of that policy. In other words, its underwriting is restricted to those issues and to such amounts as the LIC would itself like to hold in its portfolio of investments. It is not interested simply in the earning of an underwriting commission.

The viewpoint of the newly set up UTI is essentially the same as that of the LIC. The UTI's policy, however, appears to be somewhat more conservative than that of the LIC; it has been showing interest briefly in debenture issues and in issues of already established companies. Its interest in the issues of entirely new companies seems to be insignificant.

Both the LIC and the UTI enjoy the reputation of being conservative investors; their participation, therefore, helps to stimulate wider interest in the issues among the investing public.

(3) *Stockbrokers*

Stockbrokers form an important class of underwriters. They underwrite mainly on the strength of their clientele. Their capacity to underwrite is determined directly by their capacity to distribute the securities, because normally they cannot afford to lock up their own funds in holding the issues. This explains why stockbrokers are very active as underwriters during boom periods. Generally, they limit their participation in underwriting to amounts which are thought to be within their distributive capacity. In most cases, therefore, the amount underwritten by an individual brokerage firm is relatively small.[17]

The number of brokerage firms interested in underwriting new issues has varied with market conditions. Nearly as many as forty brokerage firms participated in underwriting one or more issues during 1961 as compared to about one-fourth that number in 1960.[18] The large brokerage firms are concentrated in the three metropolitan cities where the important stock exchanges are located. Brokerage firms at other centres also

[17]The amount of a single issue underwritten by individual brokerage firms during recent years has been found to range commonly between Rs. 1 lakh and Rs. 10 lakhs only, in the case of share issues. This is not to say that underwriting of much larger amounts by individual brokerage firms is unknown.

[18]According to a study made by the *Economic Times* (17 Jan. 1966), 107 brokerage firms underwrote new issues during the period from Jan. 1961 to Dec. 1965. Only sixteen of these firms had participated in the underwriting of fourteen or more issues during this whole period. There were seven firms which underwrote over Rs. 1 crore each for the five-year period.

occasionally participate in underwriting. During recent years many brokerage houses have been trying to improve their internal organization for the purpose of placing new issues, mainly by maintaining regular lists of clients and keeping continuous contact with them through circulars. They are, however, not allowed to advertise nor to engage in the doorbell ringing methods widely prevalent in the United States.

In contrast to the long-term view taken by the special institutions and the institutional investors, stockbrokers in general place primary emphasis on the immediate market prospects of the issue; for them a successful flotation appears to be more important than a sound venture. In fact, most stockbrokers ordinarily are willing to underwrite an issue only if they regard the issue as a 'hot cake' and, therefore, readily saleable; their approach is thus highly selective with almost exclusive preference for issues which are likely to be fancied by the public. They are not equipped to carry out any detailed technical examination of industrial proposals, although the reputable and responsible brokerage firms do satisfy themselves about the business integrity of the promoters, before lending their name to an issue.

(4) *Commercial Banks*

Banks neither intend to acquire the securities for themselves as the long-term institutional investors do, nor do they actively engage in the distribution of securities like the stockbrokers. They underwrite mainly on the basis of their financial strength and reputation. No bank, however, is ordinarily willing to lock up any significant portion of its funds in industrial shares and debentures or to incur much risk. They are known to be conservative institutions and are believed to underwrite only in the case of the strongest companies, or new companies backed by the strongest ownership groups.[19] Their approach to underwriting seems to be more selective than that of the special institutions. Also as compared with the special institutions and the LIC, there is perhaps a larger subjective element in a bank's decision to underwrite. They are private institutions[20] and are

[19]See Chap. 3.

[20]The Government-owned State Bank of India, the largest of the Indian commercial banks, does not normally engage in the underwriting

in intimate day-to-day contact with business firms. Some of them have affiliations with particular business houses which started them, and which may still control them or are represented on their boards. The various measures, however, of banking reform introduced since Independence have considerably reduced the scope for the use of banking institutions to serve the ends of controlling groups. The larger of the commercial banks have since been nationalised.

(5) *State Governments*

Several state governments in India have in recent years been found to participate in underwriting of new issues, or to take up large blocks of shares. They do so with a view to supporting and encouraging enterprises within their territories. Lately, a number of state governments have set up government-owned industrial development corporations in addition to the State Financial Corporations, which already exist in all the states, but which do not normally participate in underwriting. The industrial development corporations participate in underwriting directly and also subscribe to share capital of private enterprises. They are all, however, in an embryonic stage and their quantitative significance is not much at present.

(6) *Promoters*

Pormoters, or financial and non-financial companies controlled by promoters, have also been found to participate in underwriting in some cases. Since they are otherwise interested in the issue, they cannot be said to exercise independent judgment or offer disinterested guidance to investors generally.

It is of interest to note that the composition of the underwriting group is of considerable importance in influencing the judgment of the investing public. Entrepreneurs, who are not widely known, endeavour to include in the underwriting group one or more of the well-known institutions. The participation of such an institution may be necessary, not only

business. It is statutorily prohibited from purchasing or underwriting shares of companies. It is permitted to buy or underwrite debentures, but normally dces not engage in underwriting even debenture issues.

for inducing the public to subscribe to the securities, but even to give a lead to those underwriters, such as stockbrokers, who can play a useful supporting role in the underwriting organization, but not the main role of originating institutions. The participation of special institutions, and particularly of institutional investors, serves to give the investing public a kind of assurance about the long-term soundness of the ventures and evokes a better response to the issues.

On the other hand, entrepreneurs who are already well-known and command high reputation seem to prefer, where possible, to get their issues underwritten by non-official[21] agencies, that is, by banks and stockbrokers. These agencies are more business-like than the official agencies and make no time-consuming inquiries. The result is that the cream of the underwriting business goes to stockbrokers and banks, leaving special institutions in particular to handle the most difficult type of business. The LIC and the UTI seem to get better fare than the special institutions. The order of preference, so far as the issues are concerned, seems to be to place stockbrokers and banks first, and the special institutions last. Of course, in the case of larger issues, it is usually necessary to approach as many underwriters as possible.

The rates of underwriting commission charged by the underwriting institutions in India have become more or less standardized at 2.5 per cent of the issue price, in the case of shares (both equity and preference), and 1.5 per cent in the case of debentures.[22] An additional 1 per cent in the case of shares and 0.5 per cent in the case of debentures (being the usual rates of brokerage payable to recognized brokers in respect of subscriptions obtained through them) is usually payable to the underwriters, on the amount of securities which the underwriters may be called upon to take up. A few issuers have succeeded in getting their issues underwritten at lower rates.

[21]In the present context, official agencies include all those institutions which are owned or sponsored by the Government.

[22]A maximum underwriting commission of 5 per cent in the case of shares and 2.5 per cent in the case of debentures is prescribed by Section 76 of the Companies Act. The Government of India has, however, sought, through its control over capital issues, to restrict underwriting commission and brokerage to an over-all limit of 3.5 per cent only.

(3) A Quantitative Measure of the Growth of Underwritng

This section attempts to measure the growth of underwriting practice, and to ascertain the relative contributions of the various underwriting agencies.

It is reasonable to presume that most issuers ordinarily prefer to get the issues underwritten. There are, however, instances where an issuer might feel so overwhelmingly confident of the success of an issue that he might not resort to underwriting at all. Thus further issues offered to existing shareholders on a 'rights' basis are frequently not underwritten, because they often include a bonus element.[23] Similarly, issues of even new companies, promoted under exceptionally influential auspices and by financially strong groups, are sometimes made without underwriting. It is not, however, merely a matter of promoters' reputation and financial strength; other factors, such as the size of the issue, the type of security, the nature of the industry, and the current market conditions have all to be taken into account by the promoters while considering whether they could dispense with underwriting.

Since further issues by existing companies to their shareholders are often made on bonus terms and do not in such cases need to be underwritten, the growth of underwriting practice may best be examined in relation to those issues which are offered through prospectus.[21] The analysis in this chapter is, therefore, based on prospectus issues only.[25]

Prospectus issues advertised in the *Times of India* (Bombay)[26] form the basis of the study for period 1951-63.

[23]That is, the issue price of the securities is set lower than the market price.

[24]This does not imply that 'rights' issues are never underwritten.

[25]Incidentally, it may be noted that issues through prospectus have predominated the new issue activity during recent years. According to the data collected by the Reserve Bank, issues through prospectus accounted for 63 per cent of the total amount of issues made by non-government public limited companies during 1960-66, See *RBI Bulletin*, June 1964, p. 743, Table 5.

[26]The largest number of public offerings in India are advertised in this particular daily newspaper which has the widest circulation in Bombay, the most important financial centre in India. Discussions with

TABLE 23.1

PERCENTAGES OF THE NUMBER AND AMOUNT OF PUBLIC OFFERS OF SHARES AND DEBENTURES IN INDIA UNDERWRITTEN DURING 1951-65

Year	*Percentage of the number of issues underwritten*	*Percentage of the amount of issues underwritten*
1951	11	2
1952	—	—
1953	25	27
1954	11	7
1955	28	42
1956	32	18
1957	22	32
1958	39	56
1959	47	69
1960	44	56
1961	67	78
1962	69(69)	82(75)
1963	78(75)	84(83)
1964	(84)	(88)
1965	(97)	(99)

Notes: (1) The amount underwritten is expressed as percentage of the amount offered to the general public, and not as percentage of the total issues, because underwriting is needed to cover only the amount offered for public subscription. The amount offered to the general public is derived from total issue, by excluding from it the securities taken up by promoters, directors, and foreign collaborators, etc.

(2) Simultaneous issues of different types of securities by a company have been treated as separate issues. For instance, if an issue consisted both of equity and preference shares, each type of security has been regarded as a separate issue.

(3) Figures within brackets give comparable data for recent years, published by the *Economic Times*, 17 Jan. 1966, pp. 1, 5.

Comparable data for the years 1962–65, published by the *Economic Times* in its survey of underwritings, are also presented in order to bring the information up to date.

Table 23.1 shows the number and amount of prospectus issues underwritten as percentages of the total number and amount of issues offered for public subscription, each year, for the period

stockbrokers indicated that 80 to 90 per cent of public offerings were advertised in this paper. A fairly comprehensive coverage of prospectus issues can be claimed for the present study.

TABLE 23.2

PERCENTAGES OF THE NUMBER AND AMOUNT OF ISSUES UNDERWRITTEN BY TYPE OF SECURITY, 1951-65

Year	*Percentage of the number of issues underwritten*			*Percentage of the amount of issues underwritten*		
	Equity	*Preference*	*Debenture*	*Equity*	*Preference*	*Debenture*
1951-54	10	17	Nil	5	9	Nil
1955	12	33	50	17	51	61
1956	33	30	*	13	29	*
1957	25	14	33	33	11	42
1958	30	50	50	37	90	71
1959	20	60	100	34	84	100
1960	37	70	*	49	77	*
1961	65	72	*	74	93	*
1962	60	92	100	60	96	100
1963	72	90	100	78	96	100
1964	(85)		(100)	(83)		(100)
1965	(98)		(100)	(97)		(100)

*The study included no public offers of debentures in respect of these years.

Note: Figures within brackets against 1964 and 1965 give comparable data published by the *Economic Times*, 17 Jan. 1966, pp. 1, 5.

1951-65. During 1951-54 as a whole, only 6 per cent of the amount of public offers of shares and debentures were underwritten. This proportion has steadily improved since 1955, being about 80 per cent (by amount) during the three years 1961-63, and reaching very near 100 per cent in 1965. Underwriting has thus become a universal practice in the case of public offers of new corporate issues. The progress of underwriting with respect to each class of security is shown in Table 23.2. It may be noted that, until recently, underwriting of equity issues was less common than that of preference and debenture issues. The difference has tended to become less marked.

Tables 23.3–23.6 indicate the relative importance of the different underwriting institutions, during the period 1955-63, on the basis of their share in the total underwriting business.[27]

[27]No account has been taken here of sub-underwriting because the relevant data are not available. The practice does not appear to be very widespread at present.

The period 1955-63, covered by this analysis, has benn broken into two sub-periods, so as to throw light on the evolution and diversification of the underwriting mechanism since 1955. Data collected by the *Economic Times* for the years 1964 and 1965 are presented separately in Table 23.7.

TABLE 23.3

RESPECTIVE SHARES OF THE VARIOUS UNDERWRITING INSTITUTIONS IN THE UNDERWRITING OF EQUITY ISSUES, 1955-63

(Amount in Rs. lakhs)

Underwriter	*Period I (Jan. 1955-June 1959)*		*Period II (July 1959-Dec. 1963)*	
	Amount underwritten	*Per cent*	*Amount underwritten*	*Per cent*
	(1)	(2)	(3)	(4)
1. ICICI	250.18	81.40	273.60	7.19
2. IFC	—	—	216.00	5.68
3. LIC	—	—	282.25	7.42
4. Banks	4.15	1.35	744.19	19.57
5. Investment companies	46.00	14.97	268.60	7.06
6. General insurance companies	5.00	1.63	40.59	1.07
7. State industrial development corporations	—	—	58.50	1.54
8. Madras Industrial Investment Corporation	—	—	327.75	8.62
9. SFCs	—	—	15.00	0.40
10. Stockbrokers	—	—	1,288.47	33.88
11. State governments	—	—	—	—
12. Others	2.00	0.65	288.40	7.58
Total	307.34	100.00	3,803.35	100.00

In the first period (that is, from January 1955 to June 1959), the ICICI occupied a dominant position. It was more or less the only important underwriting institution for equity issues, its share in the underwriting of such issues during this period being as high as 81.4 per cent of the total (Table 23.3). Very few other institutions showed interest in the underwriting of equity issues. Equity issues of more than a very moderate

size[28] presented considerable difficulty. This was the period when an underwriting mechanism was being evolved and developed almost from scratch.

A larger number of institutions showed interest in the underwriting of preference shares and debentures (Tables 23.4 and 23.5), the most important being commercial banks, which underwrote slightly over half of the total. The LIC, formed in September 1956, was just evolving its policies, but it seemed to

TABLE 23.4

RESPECTIVE SHARES OF THE VARIOUS UNDERWRITING INSTITUTIONS IN THE UNDERWRITING OF PREFERENCE ISSUES, 1955-63

(Amount in Rs. lakhs)

Underwriter	Period I (Jan. 1955-June 1959)		Period II (July 1959-Dec. 1963)	
	Amount underwritten	Per cent	Amount underwritten	Per cent
	(1)	(2)	(3)	(4)
1. ICICI	100.00	20.99	167.50	12.20
2. IFC	37.50	7.87	213.38	15.54
3. LIC	—	—	273.49	19.92
4. Banks	248.94	52.25	321.01	23.38
5. Investment companies	—	—	16.00	1.16
6. General insurance companies	5.00	1.05	20.75	1.51
7. State industrial development corporations	—	—	2.50	0.18
8. Madras Industrial investment Corporation	—	—	103.00	7.50
9. SFCs	—	—	15.00	1.09
10. Stockbrokers	45.00	9.45	192.19	14.00
11. State governments	—	—	46.25	3.37
12. Others	40.00*	8.40	2.00	0.15
Total	476.44	100.00	1,373.07	100.00

*Underwriter's name could not be ascertained in this case.

[28]It was not easy to arrange underwriting even for a sum of Rs. 1 crore in the case of equity issues. Only the more resourceful of the promoters, who had investment and other companies under their control, could do so.

be interested chiefly in debentures. The IFC had hardly made its debut in the underwriting field.

TABLE 23.5

RESPECTIVE SHARES OF THE VARIOUS UNDERWRITING INSTITUTIONS IN THE UNDERWRITING OF DEBENTURE ISSUES, 1955 63

(Amount in Rs. lakhs)

Underwriter	*Period I (Jan. 1955-June 1959)*		*Period II (July 1959-Dec. 1968)*	
	Amount underwritten	*Per cent*	*Amount underwritten*	*Per cent*
	(1)	(2)	(3)	(4)
1. ICICI	50.00	14.71	245.00	11.34
2. IFC	—	—	168.00	7.77
3. LIC	25.00	7.35	825.00	38.18
4. Banks	185.00	54.41	295.00	13.65
5. Investment companies	25.00	7.35	30.00	1.39
6. General insurance companies	25.00*	7.35	95·00	4.40
7. State industrial development corporations	—	—	—	—
8. Madras Industrial Investment Corporation	—	—	—	—
9. SFCs	—	—	—	—
10. Stockbrokers	30.00	8.82	473.09	21.89
11. State governments	—	—	—	—
12. Others	—	—	30.00	1.39
Total	340.00	100.00	2,161.00	100.00

*This was underwritten by the New India Assurance Company Limited in 1955, that is, before the nationalization of life insurance business.

Taking all types of securities (Table 23.6), the ICICI and the commercial banks, put together, accounted for nearly 75 per cent of the total underwriting during the first period. The balance was shared by stockbrokers, investment companies, insurance companies (including the LIC), the IFC, and others. Considered singly, the ICICI was the most important

underwriting institution, its share being about 36 per cent of the total underwriting.

TABLE 23.6

RESPECTIVE SHARES OF THE VARIOUS UNDERWRITING INSTITUTIONS IN THE UNDERWRITING OF ALL TYPES OF ISSUES, 1955-63

(*Amount in Rs. lakhs*)

Underwriter	*Period I (Jan. 1955-June 1959)*		*Period II (July 1959-Dec. 1963)*	
	Amount underwritten	*Per cent*	*Amount underwritten*	*Per cent*
	(1)	(2)	(3)	(4)
1. ICICI	400.18	35.61	686.10	9.35
2. IFC	37.50	3.34	597.38	8.14
3. LIC	25.00	2.22	1,380.74	18.82
4. Banks	438.09	38.98	1,360.20	18.54
5. Investment companies	71.00	6.32	314.60	4.29
6. General insurance companies	35.00	3.11	156.34	2.13
7. State industrial development corporations	—	—	61.00	0.83
8. Madras Industrial Investment Corporation	—	—	430.75	5.87
9. SFCs	—	—	30.00	0.41
10. Stockbrokers	75.00	6.67	1,953.75	26.63
11. State governments	—	—	46.25	0.63
12. Others	42.00	3.74	320.40	4.37
Total	1,123.78	100.00	7,337.51	100.00

Since 1959, underwriting organization has tended quickly to broaden and diversify. A marked shift occurred at about this time in the investors' preference in favour of equities, leading to strong boom conditions. With the appearance of boom conditions, stockbrokers came to the forefront as underwriters of equity shares, and accounted for a third of the total of equity issues underwritten during the latter period. Commercial banks also began to display considerable interest in the underwriting of equity shares, and accounted for about 20 per

cent of the total. The LIC, the IFC, and some regional institutions too, increasingly participated in the underwriting of equity shares. The increased participation of other institutions is reflected in a sharp reduction in the ICICI's share in the underwriting of equity shares, from 81 per cent in the first period to only 7 per cent in the second (Table 23.3). The broadening and diversification of the underwriting organization since 1959 can be easily observed from Tables 23.3-23.6 by looking at the percentage figures. The establishment of the IDBI and the UTI in 1964 has taken this development an important step further (Table 23.7).

The importance of the ICICI, the IFC, and the LIC, as also of the newly created IDBI and UTI, in the system of underwriting new issues in India should be judged not simply in terms of the amounts underwritten by them. Though they may underwrite no more than a fraction of a particular issue, their participation lends prestige to the issue, and conveys to the investor an implicit guarantee about its soundness as a long-term investment. Their participation in an issue, therefore, attracts the genuine investor. In this respect, their role is comparable to that of the well-known issuing or originating houses of the UK and USA.

The importance of the institutional underwriters, in India, in the underwriting system is better indicated by the fact that very few underwriting groups are formed without one or more of the well-known institutions. An examination of the constitution of underwriting groups, formed during 1955-63 for the underwriting of issues covered by the present analysis, showed some interesting results which are presented in Table 23.8. The table shows that of 219 cases of underwriting analysed, 125 were partly or wholly underwritten by one or more of the following three, viz. the ICICI, the IFC and the LIC; 42, by banks *without* any of the above three; 37 by stockbrokers *without* any of the above four (the ICICI, the IFC, the LIC and the banks); and 15, by others *without* any of the above five. Thus, over three-fourths of the number of underwriting groups included the ICICI, the IFC, the LIC, and/or the banks; less than one-fourth of the groups were formed without the presence of any of these important institutions, being composed, in most cases, wholly of stockbrokers. Thus, taking the period 1955-63 as a

TABLE 23 7

RESPECTIVE SHARES OF THE VARIOUS UNDERWRITING INSTITUTIONS IN THE UNDERWRITING OF ALL TYPES OF ISSUES, 1964 AND 1965
(*Economic Times* Study)

(*Amounts in Rs. lakhs*)

Underwriter	*1964*		*1965*	
	Amount underwritten	*Per cent*	*Amount underwritten*	*Per cent*
	(1)	(2)	(3)	(4)
1. ICICI	339.3	10.9	555.2	12.2
2. IFC	309.2	10.0	498.4	11.0
3. IDBI	19.0	0.6	304.0	6.7
4. LIC	640.5	20.6	1,082.7	23.8
5. UTI	5.3	0.2	681.3	15.0
6. Banks	429.8	13.9	89.6	2.0
7. State industrial development corps. and state governments	349.4	11.3	335.4	7.4
8. Stockbrokers, Investment companies, and general insurance companies	1,010.2	32.6	994.6	21.9
Total	3,102.7	100.0	4,541.2	100.0

Source: *The Economic Times*, 17 Jan. 1966, Table I, p. 5.

whole, although the four leading institutional underwriters (ICICI, IFC, LIC and banks) were responsible for only 58 per cent of the amount underwritten (Table 23.6), they were present in as many as 76 per cent of the underwriting groups (Table 23.8). The influence of the institutional underwriters may, therefore, be said to be fairly pervasive in the whole underwriting field.

In one sense, however, the special underwriting institutions in India play a more limited role than the British and American issuing or originating houses. Both in the UK and the USA, the originating or issuing house not only investigates the new

TABLE 23.8

COMPOSITION OF UNDERWRITING GROUPS, BY CLASS OF UNDERWRITERS, 1955-63

	Equity issues	*Preference issues*	*Debenture issues*	*All types of issues*
Total number of public offerings examined	255	104	21	380
Number of public offerings which were underwritten	134	69	16	219
Underwritten partly or fully by—				
(1) ICICI	27	11	7	45
(2) IFC	22	18	1	41
(3) LIC	44	36	9	89
Either of the above three	66	48	11	125
(4) Banks				
(*a*) jointly with ICICI, IFC, or LIC	32	9	5	46
(*b*) without any of the above three	28	10	4	42
(5) Stockbrokers				
(*a*) jointly with ICICI, IFC, LIC or banks	60	17	9	86
(*b*) without any of the above four	30	6	1	37
(6) Others, such as investment companies, etc., without any of the above five	10	5	—	15

Note: Where a public offering comprised more than one type of security, each type of security has been counted as a separate issue.

issue proposal, but also usually takes upon itself the responsibility of arranging the underwriting of the whole issue. by forming an underwriting group.[29] They are able to do so because of their close connections with other underwriters or

[29]A point of contrast between London and New York new issue markets is that, while the New York originating banker negotiates with the issuer in the capacity of an agent for the members of the underwriting group, the London issuing house acts in the capacity of a principal rather than an agent. This is, however, only a difference in

sub-underwriters. The issuing company's anxiety is, therefore, more or less over, once it has satisfied the originating or issuing house about the soundness and feasibility of its proposal. In India, on the other hand, the special underwriting institutions usually do no more than indicate to the issuing company the fraction of the total issue that they may be willing to underwrite on their own. They accept no responsibility to bring together the other underwriters. To get the issue fully underwritten, the issuing company itself usually has to negotiate directly with each of the underwriters. What is needed, therefore, is greater integration in the underwriting organization. This can be brought about only if the institutions develop a consortium approach. A hopeful development in this connection is the attempt being made by the IDBI to evolve close working relationships with other financing institutions.[30]

It may, however, be stated that the willingness of these institutions (viz., ICICI, IFC, LIC) to underwrite even a part of an issue often helps the issuing company, indirectly, to find other underwriters for the balance. Many brokers during the last few years have been willing to follow the lead given by these institutions. Hence these institutions form the backbone of the underwriting system in India. One may call them underwriting leaders. The other institutions may be said to play only a subsidiary and supporting role in the underwriting organization.

Concluding Observations

Any observer of the new issues market in India can hardly fail to be impressed by the tremendous improvement since the mid 'fifties in the organization of the market.

Beginning from 1956, a strong underwriting organization has come into existence, and the practice of underwriting of new issues has tended to become universal. The meticulous scrutiny of new issue proposals by institutional underwriters has done much to raise the standards of the new issues market. Changes in company law, the tightening of the listing

form not in substance. See E. Nevin, 'Some Reflections on the New York New Issue Market', *Oxford Economic Papers* (New Series), Vol. XIII (Feb. 1961). pp. 85-6.

[30]See IDBI, *Second Annual Report* (1965-66), p. 16.

requirements of stock exchanges, the control of capital issues, and industrial licensing have also worked in the same direction. The combined effect of all these has been to eliminate almost altogether the wild-cat type of flotations which were common during the 'forties.

There are, however, some fundamental problems which remain.

The first of these concerns the general relationship between the demand for, and the supply of, industrial securities. Despite the spectacular over-subscriptions to new issues of certain companies floated in the years 1959-61, it appears that genuine investment demand for industrial securities in general and for securities of new enterprises in particular, has failed to keep pace with the supply of such securities. The large over-subscriptions in question have led some people to believe that the Indian industrial securities market is fully capable of meeting the expanding demand for capital from private industry. A closer analysis reveals a somewhat different picture. Over-subscription was largely a feature of those issues which were expected to command a substantial premium over the issue price immediately after the issue, and which, therefore, gave opportunity for short-term capital gain. There was a veritable scramble for such issues, particularly during 1960 and 1961, with many investors putting in multiple applications, so that they could hope to secure at least one, if allotment was made by casting lots. In the case, however, of most other issues, which were not expected to command an immediate market premium over the issue price, it has always been difficult to get the securities fully subscribed by the public, and the underwriters of such issues have usually been called upon to take up a substantial part of the issues. This is clearly indicated by the underwriting experience of all the special institutions.

The underwriting organization in India is at present not adequately supported by genuine investment demand for new issues, making it necessary for the underwriters to fill in the breach. The improvements in the organization of the new issues market effected during the last decade have gone a long way to broaden the market. More stress will have to be laid in the future on the development of investment trusts, and on the expansion of institutional demand for industrial securities.

The second problem relates to small issues. The machinery of the market may be regarded now as fairly adequate so far as issues of large companies are concerned. There are, however, not many institutions in India which will be interested in the placing of issues of small companies. In fact, with the trend towards concentration of resources in a few large investment institutions, the position of the small company may be said to have become more difficult, so far as the raising of equity capital is concerned. If small companies are to flourish, there is a need to develop institutional facilities for the placing of small issues.

Post Script

RECENT DEVELOPMENTS IN UNDERWRITING OF NEW ISSUES

The basic skeleton of the underwriting organization in India, as also the basic policies of the underwriting institutions, can be said to have emerged almost full-grown by the mid-1960s. The changes that have taken place since then are of a relatively marginal character.

It has been shown in the earlier pages that the practice of underwriting had become almost universal by the mid-sixties. The position in this regard in the early seventies remains substantially unchanged. Table 23.9 indicates how widespread is the underwriting practice in India, by giving percentages of the number and amount of public offers of shares and debentures underwritten during 1971-74.

As regards the relative shares of the various classes of underwriters (see Tables 23.10 and 23.11), there have been some striking changes since the mid-sixties. The all-India development banks (IDBI, ICICI and IFCI) together did between one-fourth to one-third of total underwriting during the years 1971–74. The leading position among them is now occupied by the IDBI which was created in 1964 to function as the apex development bank for industry.

The commercial banks, which provided fairly strong support to underwriting operations before the creation of the IDBI, seem to have largely withdrawn from this field after 1964. This is indicated by the sharp fall in their relative share in total

TABLE 23.9

PERCENTAGE OF PUBLIC ISSUES OF SHARES AND DEBENTURES UNDERWRITTEN, 1971-74.

Year	*Equity*	*Pref.*	*Deb.*	*All Securities*
(Percentages underwritten of *number* of issues)				
1971	81.1	95.7	100.0	87.6
1972	78.8	89.5	100.0	83.3
1973	83.2	95.7	75.0	86.5
1974 (Jan-June)*	73.3	95.2	100.0	80.0
All years	80.5	93.7	94.1	84.3
(Percentages underwritten of *amount* offered to public)				
1971	81.1	98.7	100.0	88.4
1972	90.6	96.1	100.0	94.2
1973	93.7	99.1	71.8	80.3
1974 (Jan-June)	88.0	98.9	100.0	91.9
All years	89.7	97.9	97.9	89.2
No. of issues analysed	276	128	17	421

Source: Compiled from studies on 'Survey of Public Response to Capital Issues by the Private Corporate Sector', *Reserve Bank of India Bulletin*, September 1974 (pp. 1724-39) and March 1975 (pp. 190-203).

underwriting business from the level of 15-20 per cent during 1959-64 to only 3-4 per cent thereafter. The relative share of the LIC in total underwriting also declined significantly from over one-fifth in 1964 and 1965 to just around 11 per cent for the period 1971-74 as a whole, with a much shaper decline in the years 1973 and 1974. Both the LIC and the UTI have usually been more willing to underwrite debentures and preference shares than equity shares: during 1971-74 the two together underwrote about 40 per cent of debenture issues, 28 per cent of preference issues but only 8 per cent of equity issues. On the other hand, stockbrokers have definitely and significantly been expanding their role in the underwriting business. This may have been induced partly by considerable shrinkage in their traditional brokerage business, specially after the ban on forward trading in shares. Their relative share in underwriting had been in the range of 15-20 per cent during 1960-65; it rose

to 28-29 per cent during 1971 and 1972, and was over 40 per cent during 1973 and 1974.

TABLE 23.10

PERCENTAGE SHARES OF THE VARIOUS CLASSES OF UNDERWRITERS IN THE UNDERWRITING OF CORPORATE ISSUES, JAN. 1971-JUNE 1974.
(By Type of Security)

(Percentages)

Class of underwriter	*Equity*	*Preference*	*Debentures*	*All Securities*
IDBI	20.5	6.0	8.8	15.5
ICICI	6.4	14.8	10.1	8.7
IFCI	5.8	9.3	4.9	6.2
Sub-total for all-India development banks	32.7	30.1	23.8	30.4
LIC	3.9	21.3	23.8	11.1
UTI	3.9	7.0	16.3	7.0
General insurance & investment co.	3.0	13.0	7.1	5.6
Commercial banks	4.0	4.2	3.7	4.0
SFCs	1.3	3.2	—	1.4
SIDCs	4.5	12.4	—	5.0
Stockbrokers	46.6	8.5	25.3	35.5
Total	100.0	100.0	100.0	100.0
Amount of issues analysed (Rs. crores)	84.2	23.7	28.5	136.4

Source: Same as for Table 23.9.

An interesting development in the underwriting field in recent years has been the trend towards formation of bigger underwriting groups for the underwriting of individual issues. In the period before 1965, the number of participants in an underwriting group was usually small, rarely exceeding 10 or 12. Underwriting groups formed in recent years frequently have a much larger number of participants: about one-third of the equity issues analysed by us for the period January 1972-June 1975 had over 20 underwriters in each underwriting group. In a few groups, the underwriting participants numbered between 50-70. This is very much a reflection of the entry of a larger number of stockbrokers into the underwriting business; to some

TABLE 23.11

PERCENTAGE SHARES OF THE VARIOUS CLASSES OF UNDERWRITING INSTITUTIONS IN THE UNDERWRITING OF CORPORATE ISSUES, JAN. 1971-JUNE 1974

(By Year)

(*Percentages*)

Class of underwriter	*1971*	*1972*	*1973*	*1974 (Jan June)*
IDBI	10.9	19.3	14.0	13.2
ICICI	10.5	7.3	6.0	11.3
IFCI	6.0	7.4	5.9	4.2
Sub-total for all-India development banks	27.4	34.0	25.9	28.7
LIC	19.2	14.2	3.9	7.7
UTI	9.8	8.7	3.9	5.5
General insurance & investment co.	2.9	6.6	6.9	5.3
Commercial banks	3.1	3.9	3.0	5.6
SFCs	1.3	1.0	1.8	1.5
SIDCs	7.0	3.5	7.9	2.5
Stockbrokers	29.3	28.0	46.7	43 1
Total	100.0	100.0	100.0	100.0
Amounts of issues analysed (Rs. crores)	20.8	56.4	35.7	23.0

Source: Same as for Table 23.9.

extent it could be attributed to large-sized issues. We present in Table 23.12 an analysis showing the frequency distribution of capital issues of different sizes, made during 1972-75, according to the number of participants in the underwriting group. The size of an underwriting group is found to be related to the size and character of an individual issue (see last row of Table 23.12).

A related development is the adoption of consortium-approach by underwriting institutions, indicating the emergence of closer working relationships among them. So far as the major public financial institutions are concerned, the IDBI, in its role of an apex institution, initiated in 1965 monthly Inter-Institutional Meetings of the senior executives of the IDBI, the IFCI, the ICICI, the LIC and subsequently the UTI. These meetings help to coordinate the institutional policies in the field of project

TABLE 23.12

FREQUENCY DISTRIBUTION OF PROSPECTUS ISSUES OF EQUITY SHARES ACCORDING TO NUMBER OF PARTICIPANTS IN THE UNDERWRITING GROUP, 1972-75.

No. of participants in an underwriting group	*Ferquency distributions for the different sizes of issues*							
	Upto Rs. 5 lakh	*Rs. 5-10 lakh*	*Rs. 10-25 lakh*	*Rs. 25-50 lakh*	*Rs. 50-100 lakh*	*Rs. 100-200 lakh*	*Over Rs. 200 lakh*	*All sizes of issues*
None	9	15	13	3	—	2	2	44
1	3	1	1	—	—	1	—	6
2	1	2	1	2	—	—	—	6
3	3	5	2	1	1	1	—	13
4	1	2	4	1	1	—	—	9
5	—	3	6	1	—	—	—	10
6-10	1	4	16	10	5	1	—	37
11-15	—	3	29	9	1	1	1	44
16-20	—	1	23	11	6	—	1	42
21-25	—	—	14	9	1	2	—	26
26-30	—	—	5	5	2	1	1	14
31-40	—	—	3	15	7	4	1	30
41-50	—	—	—	5	3	—	3	11
51-60	—	—	—	1	—	—	1	2
61-70	—	—	—	—	—	—	2	2
over 70	—	—	—	—	—	—	—	—
No. of issues analysed	18	36	117	73	27	13	12	296
Average No. of underwriting participants per underwritten issue	3	6	15	23	23	21	41	

Note: The size of issue in this table refers to the amount of issue made available for public subscription, i.e., after excluding all firm subscriptions by promoters and others. The table is based on an analysis of prospectuses issued by companies during the period from January 1972 to June 1975. Our analysis was restricted to offers of equity issues.

financing. The meetings also consider project proposals for the provision of financial assistance on a consortium basis. As regards the stockbroking firms, they are frequently brought together, by appointing a 'Managing Broker' or 'Principal Broker' to the issue, the managing broker being usually remunerated by payment of a commission, equal to half a per cent of amount of issue in the case of most equity issues.

A few commercial banks, such as the State Bank of India and the National and Grindlays Bank, have set up merchant banking divisions and act as 'Managers to the Issue' providing advisory and other procedural services to their clients in connection with new issues, their usual commission rate for this service being half a per cent of the amount of issue.

These developments show that, from the organizational viewpoint, the new issue market in India has assumed a fairly developed character by now. The transformation that has taken place between 1955 and 1975 is complete and truly remarkable.

24

Investment Trusts*

L.C. Gupta

This paper explains the nature and types of investment trusts and shows that they are a relatively underdeveloped segment of India's financial institutions. It pleads for a decentralised and diversified structure of such investment institutions. In particular, it emphasizes the need for encouraging both unit trusts and investment trust companies in the present stage and context of India's industrial development.

.Editor

An investment trust, whatever its legal form, is essentially an organizational device to secure the twin benefits of wide diversification and skilled management for the small investor in the field of corporate securities. The economic significance of this institution will be clearer if its development is viewed against the background of the evolution of joint stock enterprise.

The invention of the joint stock company made it possible to invite public participation in the capital of an industrial enterprise. This has been regarded as an important financial innovation which paved the way for large-scale enterprise.[1] The

*Taken from L.C. Gupta, *The Changing Structure of Industrial Finance in India,* Oxford: Clarendon Press, 1969, pp. 64-81.

[1] 'The invention of the joint-stock company was a technical revolution comparable to the invention of the steam-engine.' See Joan Robinson, *The Rate of Interest and Other Essays* (London, 1952), p. 86.

risk, however, of investing in the shares of any individual enterprise was great because of the uncertainty surrounding a single enterprise. A wealthy investor could limit his risk by spreading his investment over a number of enterprises, but this course was impracticable for a small investor. Hence, although the joint stock form enabled the collection of capital from much wider sources than was possible under the partnership form, investment in industrial securities still remained largely confined to the wealthier sections of the community.

The concept of investment trust must be regarded as a further advancement in financial technology, facilitating the collection of industrial capital from still wider sources, particularly from small investors, by transforming primary industrial securities, which are individually risky, into indirect securities[2] involving much less risk. Investment trusts provide the most suitable vehicle for equity investment by the common man,[3] since they enable a small investor to acquire by a single purchase a stake, not in one enterprise, but in a group of enterprises. This group may be large or small, may cover different industrial activities or be confined to a particular industrial classification, may be regional, national, or international. Although the fortunes of individual enterprises may be highly uncertain and unpredictable, industry as a whole, or even particular sections of it, may have a bright future. Hence shares (or units) of investment trusts have a wider appeal than the primary securities issued by individual enterprises.

The object of this chapter is twofold: firstly, to examine the present development and structure of investment trusts in India, and secondly, to consider certain issues of future policy in relation to investment trusts.

The plan of the chapter is as follows: the next section will survey the private investment trust companies in India. This will be followed in section 2 by a discussion of unit trusts

[2]Primary securities are those which are issued by non-financial economic units while indirect securities are issues of financial institutions. See John G. Gurley and Edward S. Shaw, *Money in a Theory of Finance*, Washington, D.C., 1960, pp. 4 and 59-60.

[3]See Investment Company Institute, *Management Investment Companies*, a monograph prepared for the Commission on Money and Credit, Englewood Cliffs, N.J., 1962, p. 90.

in general. Section 3 will examine the scheme of the Unit Trust of India and section 4 some issues of Government policy. Finally, section 5 contains the concluding observations.

(1) PRIVATE INVESTMENT TRUST COMPANIES IN INDIA

There is at present no clearly recognized category of investment trust companies in India. It is true that certain official and non-official publications class some companies in the category of 'investment trusts' or 'investment companies'; a closer examination of these classifications, however, revealed that they include a mass of heterogeneous companies engaged in such diverse financial business as hire-purchase, general financing, mortgage and other lending, trading and speculation in shares or land, investing in shares and immovable property, and managing agency work.

In a study published in 1960, the Reserve Bank of India attempted to survey the working of investment trusts in India.[4] This study produced hardly any significant data on the subject. Its main shortcoming was its failure to distinguish clearly the genuine investment trust companies from the other financial enterprises. The study was stated to be based on information from the annual reports of thirty-two public limited investment companies. Only a few of these could be genuine investment trusts. The study made available no aggregate data about the selected companies except by citing a few examples, not all of which were those of genuine investment trusts.

Within the group of companies which have been loosely described as investment and finance companies, one may distinguish at least three basic types:

(1) *Investment-trust-type*: The distinguishing feature of this type is a high degree of diversification of the securities' portfolio. This implies that investment is made not with a view to controlling other enterprises but with the object of securing the best investment results.

(2) *Holding-company-type*: This type covers those investment companies whose primary aim is to hold and control other enterprises rather than to invest in a

[4]See *RBI Bulletin*, Oct. 1960, pp. 1445-68.

broadly diversified list of securities. Concentration rather than diversification is the characteristic feature of their investments. These companies are almost invariably affiliated to particular business groups, and their investments largely reflect the industrial interests of those groups.

(3) *Finance Companies*: This group includes companies most of which are engaged mainly in the financing of hire-purchase transactions, or miscellaneous types of financing and lending. Some of them regularly trade and speculate in shares, resulting in a certain amount of holding of shares which usually appear as their stock-in-trade. Their main business, however, is not the holding of shares for the sake of dividend income. Often the trading activity is an important source of income for these companies. Many of them combine a variety of other business with their finance business.

The threefold classification given above is fairly clear-cut conceptually.[5] Empirically, however, it is very difficult to draw these distinctions. Names of companies are frequently misleading: activities carried on by a single company often cut across more than one class of business; and the published documents of a company are not always sufficiently informative about the true nature of the company's business.

An attempt has been made here to compile data about companies which can be categorized as investment trust companies proper. With this end in view, a scrutiny was undertaken of all those companies which were reported to be engaged in the business of investment and finance in the official list of the recognized stock exchanges in India about the middle of 1963 or in *Kothari's Economic Guide and Investors' Handbook*

[5]Some companies may fall in between the investment-trust-type and the holding-company-type since their object may not be to control other enterprises, yet their investments may not show the degree of diversification appropriate to an investment trust. There are, for instance, what they call 'venture capital companies' in the U.S.A. See K.K. White, *Financing Company Expansion*, A Research Report, sponsored by the American Management Association, New York, 1964, Ch. VI.

of India,[6] or in *Investors' India Year Book.*[7] The published annual reports of all these companies were examined in order to ascertain the true nature of their business.

This investigation revealed that twenty-one of the companies listed on the Indian stock exchanges could be said to be companies whose main business seemed to be the holding of investments in shares.[8] The total paid-up share capital of these companies in 1961-62 was Rs. 14.75 crores, representing just about 2 per cent of the aggregate paid-up capital of all companies listed on the recognized stock exchanges in India. A further sorting of these twenty-one companies, on the basis of a criterion to be explained shortly, showed that only eight of them, with a paid-up capital of Rs. 4.87 crores in 1961-62, appeared to be investment-trust-type. The remaining thirteen, whose aggregate paid-up capital amounted to Rs. 9.88 crores in 1961-62, were holding-company-type.

In addition to the eight quoted companies which have been categorized as investment trust companies, two unquoted companies also seemed to fulfil the criterion of an investment trust and have been classed as such. Thus there were in all only ten companies which may be regarded as investment trust companies. Their aggregate paid-up capital in 1961-62 amounted to Rs. 5.00 crores and their investments, to Rs. 9.44 crores at book value.[9]

The criterion that has been adopted here, to mark off investment trust companies from holding companies, is that at least two-thirds of the total investment portfolio in the case of the former class must be invested in such a diversified manner that not more than 5 per cent of the total portfolio is invested in the securities of any individual company.[10]

[6]Published by Messrs. Kothari and Sons of Madras, a leading brokerage house in India.

[7]Published by Messrs. Place, Siddons, and Gough Private Limited of Calcutta, another leading brokerage firm in India.

[8]Detailed particulars relating to one company, viz., Gujarat Investment Trust Limited, Surat, which is listed on the Bombay Stock Exchange and which had a paid-up capital of Rs. 2.5 lakhs in 1961, could not be ascertained. Despite its name it does not appear to be a genuine investment trust. It has been left out of our discussion.

[9]Approximate market value Rs. 10.78 crores.

[10]The remaining one-third may be invested in any manner.

Table 24.1 presents some particulars of interest about the investment trust companies. The investment trust companies have been divided into two groups—those which had invested three-fourths or more of their total investment portfolio in such a way that the securities of no individual company formed more than 5 per cent of their total investment portfolio, have been labelled as 'diversified' investment trust companies, while those which had invested less than three-fourths, but at least two-thirds, of the total portfolio in the manner indicated above, have been classed as 'partially diversified' investment trust companies.

Six of the investment trust companies qualified for classification as 'diversified' companies with an aggregate paid-up capital of Rs. 4.33 crores in 1961-62. They held an investment portfolio of Rs. 4.48 crores (at book value). The distribution of their portfolio shows no marked bias towards any managerial group. The largest of them is the Investment Corporation of India Limited accounting for over half of the total paid-up capital and investment holdings of all the 'diversified' investment companies. Its investments are spread over more than 400 companies. The smallest company in the diversified group was the General Investment Trust Limited which had a paid-up capital of Rs. 5.53 lakhs only. It is remarkable that its relatively small investment portfolio of Rs. 8.64 lakhs was spread over as many as 163 companies, giving an average holding of only about Rs. 5,000 per company. In most of the 'diversified' companies, the largest single holding accounted for not over 10 per cent of their total investment portfolio.

There were four 'partially diversified' investment trust companies. All of them except one were extremely small-sized. Two of them were not listed on any recognized stock exchange in India. The aggregate paid-up capital of the four companies in this group in 1961-62 amounted to Rs. 67.25 lakhs, and their investments Rs. 96.79 lakhs. The selection of investments by these companies did not appear to be altogether unbiased. Three of them—Birds Investment, General Investment and Trust Company, and Investment and Finance Company—are affiliated to the well-known managing agency group of Bird-Heilgers and their investments clearly show the predominance of companies belonging to this group. The fourth company, viz., the

TABLE 24.1

INVESTMENT TRUST COMPANIES IN INDIA, 1961-62[a]

Name of the company	*Year established*	*Registered office*	*Paid-up share cap.(Rs. lakhs)*	*Investments*[b] *(Rs. lakhs)*	*Spread of investments*[c]	*Largest holding*[d]
I. '*Diversified*' *Companies*						
(1) General Inv. Trust Ltd.	1946	Udipi (S. India)	5.53	8.64	163	9.2
(2) Industrial Inv. Trust Ltd.	1933	Bombay	99.99	143.47	180	10.1
(3) Inv. Corp. of India Ltd.	1937	Bombay	220.22	517.73	413	6.5
(4) Kishore Trading Co. Ltd.	1943	Jaipur	20.00	53.96	71	8.6
(5) New India Inv. Corp. Ltd.	1936	Calcutta	23.32	45.21	117	8.4
(6) Oriental Ind. Inv. Corp. Ltd.	1943	Bombay	63.89	78.59	121	14.1
II. '*Partially Diversified*' *Companies*						
(7) Birds Inv. Ltd.	1936	Calcutta	44.00	67.95	99	7.9
(8) Inv. Trust of India Ltd.	1946	Madras	10.00	12.67	55	11.4
*(9) General Inv. & Trust Co. Ltd.	1908	Calcutta	4.25	5.06	89	9.9
*(10) Inv. and Finance Co. Ltd.	1896	Calcutta	9.00	11.11	114	11.0
Total			500.20	944.39		

[a]The accounting years of the different companies are not uniform but they relate generally to 1961 or 1962.

[b]At book value.

[c]That is, the number of companies over which investments are spread.

[d]Refers to the largest amount invested in the securities of any single company as per cent of total investments.

*These are not listed on any stock exchange in India. The rest are listed companies.

TABLE [illegible]

HOLDING-COMPANY-TYPE[a] INVESTMENT COMPANIES IN INDIA, 1961–62[b]

Name of the company	Year established	Registered office	Paid-up share capital (Rs. lakhs)	Investments[c] (Rs. lakhs)	Spread of investments[d]	Largest holding[e]	Group affiliation
1. Ashok Viniyoga Ltd.	1950	Calcutta	5.00	87.26	5	83.0	Dalmia-Jain
2. Bharat Nidhi Ltd.	1942	New Delhi	201.37	261.13	240	19.3	Dalmia-Jain
3. Calcutta Inv. Co. Ltd.	1936	Calcutta	55.00	52.59	98	23.4	—
4. Cambay Inv. Corp. Ltd.	1947	Ahmedabad	21.00	49.99	68	22.0	—
5. Clive Row Inv. Holding Co. Ltd.	1946	Calcutta	138.80	191.89	33	15.4	Andrew Yule
6. Devkaran Nanjee Inv. Co. Ltd.	1943	Bombay	25.00	29.99	57	40.1	—
7. Eastern Inv. Ltd.	1927	Calcutta	101.89	165.86	28	26.5	Bird-Heilgers
8. Nav Bharat Vanijya Ltd.	1945	Calcutta	25.00	47.05	20	29.5	J.K. Group
9. Pearl Inv. Co. Ltd.	1946	Calcutta	10.00	9.83	N.A.	45.1	—
10. Pilani Inv. Corp. Ltd.	1948	Gwalior	351.50	328.82	27	48.6	Birla
11. Shree Rishab Inv. Ltd.	1937	Calcutta	45.00	124.69	25	42.0	Dalmia-Jain
12. Industrial and Prudential Inv. Co. Ltd.	1916	Bombay	3.64	6.39	27	47.0	—
13. Marwar Trading Corp. Ltd.	1943	Jaipur	5.25	17.71	17	19.8	—
Total			988.45	1,373.20			

Note: All the companies in this table are listed on a recognized stock exchange in India.

[a]That is, investment companies whose investments are largely concentrated in a small number of enterprises. See p. 333.

[b]The accounting years of the companies are not uniform but they relate generally to 1961 or 1962.

[c]At book value.

[d]That is, the number of companies over which investments are spread.

[e]Refers to the largest amount invested in the securities of a single company as per cent of total investments.

Investment Trust of India, is, similarly associated with the South Indian firm of Kothari and Sons. However, the investments in all the four 'partially diversified' companies were spread over a substantial number of companies.

It has been stated earlier that of the 21 investment companies which were listed on the recognized stock exchanges in India, thirteen companies with a total paid-up capital of Rs. 9.88 crores were of the holding-company-type or 'undiversified' investment companies. Particulars of these companies are presented in Table 24.2. The distribution of investments in the case of most of these companies clearly revealed their affiliation. Their investment holdings were highly concentrated in enterprises belonging to particular management groups, quite often in a single company. Some of these companies gave the appearance of wide diversification as judged simply by the number of companies over which the investments were spread. For instance, the investments of Bharat Nidhi Limited were spread over 240 companies but nearly two-thirds of the total amount was concentrated in a dozen enterprises belonging to the Dalmia-Jain group. In all those cases where the share holdings gave strong evidence of group affiliation, the fact has been recorded in Table 24.2. In such cases, investment outside the particular group was found to be relatively insignificant. Some of the companies included in Table 24.2 seem to indulge in considerable trading and speculation in shares and derive substantial income from this source.

In addition to the investment companies considered above, there are a large number of others, mostly private limited companies, which have been organized to hold the investments of a particular individual or members of a family. They are often described as 'personal-holding-companies'. Such companies are hardly different in substance from proprietary organizations and are not covered by the present study.

Further light on the structure and operations of the ten companies which have been categorized as investment trusts is thrown by more detailed data presented in Tables A24.1 to A24.4 in the Appendix to this chapter. The data cover various aspects of their operation, viz., the distribution of their investments by types of securities, their capital structure, systems of management and operational results, and growth.

CONCLUSIONS OF THE SURVEY

The conclusions which emerge from this survey of investment trust companies in India may be summarized.

There are only a few genuine investment trust companies in India and most of them are very small. As a group, they occupy an insignificant place among the Indian financial institutions and are not clearly differentiated from ordinary companies. They have been stagnating despite the growing size of the corporate industrial sector.

Perhaps the most important reason why investment trust companies in India have failed to grow and to achieve the kind of popularity which they enjoy in the U.S.A. and the U.K., is that they have not been clearly differentiated in the investor's mind from ordinary companies. They are not subject to any special regulation which may raise them in the public eye to the status of a savings institution by emphasizing the idea of trusteeship. Unless the investment trust movement is based on a philosophy of trusteeship and a definite code of conduct, investment in an investment trust company is itself likely to be regarded as risky as investment in any ordinary enterprise.

Although investment trust companies in India enjoyed tax exemption since 1933,[11] this fact has never been properly publicized, and the public does not even know which companies have been granted tax exemption by the Central Board of Revenue.[12] The changes in corporate taxation introduced in 1960 have had the effect of withdrawing this exemption, by abolishing the system of giving credit to shareholders for the

[11] A notification issued by the Government of India in 1933 (Notification No. 47 of 9 Dec. 1933) exempted genuine investment trust companies from super-tax payable by companies. The companies, however, remained liable to pay income tax. Since the income tax levied on a company was, up to 1959, refundable to shareholders, an investment company would get a tax credit in respect of dividends received by it from other companies, and could, in turn, pass on the benefit of income tax paid by it to its own shareholders on distribution of dividends. Thus, up to 1959, an investment trust company was virtually free from taxation if it distributed all its income.

[12] A request by the author to the Central Board of Revenue for the names of investment trust companies which had been granted exemption from super-tax was turned down, on the ground that the information was confidential.

income tax paid by a company. The taxation of genuine investment trusts should clearly be based on the principle that an investor who invests in industrial securities through the intermediation of an investment trust should not be worse off, compared with a direct holder of industrial securities. This is recognized by the tax systems of many foreign countries.[13] The present Indian tax system places the holding of securities through an investment trust company at a disadvantage, as compared with direct holding.

(2) Unit Trusts: General

The private investment trusts which were examined in the last section were all organized as ordinary joint stock companies. This type of investment trust is usually described as investment trust company in the U.K. and as 'closed-end' investment company in the U.S.A.

The type of investment trust which has acquired greater, almost spectacular, popularity during recent years in many countries is the unit trust.[14] The American equivalent of the

[13]In the United States, an investment company pays no tax on the income and the capital gains it has distributed, if it is a regulated investment company which (1) has elected to secure special tax treatment, such election being irrevocable; (2) has derived at least 90 per cent of gross income from dividends, interest and gains from the sale of securities; (3) has received less than 30 per cent of gross income from the sale of securities held less than three months; (4) has at least half of its assets represented by cash and securities, with not more than 5 per cent of this portion of assets invested in the securities of one company; (5) holds not more than 10 per cent of the outstanding voting securities of corporation; and (6) has distributed at least 90 per cent of its net investment income and short-term of capital gains. See Investment Company Institute, op. cit., pp. 79–80.

The British tax system also recognizes the need for special tax treatment of investment trusts.

[14]In the U.K., the amount invested in unit trusts is much smaller than the amount in investment trust companies. According to the Radcliffe Committee, the total sum invested in unit trusts in June 1958 was only about £60 million, while the combined assets of investment trust companies in 1957 were £1,142 million. Since then unit trusts in the U.K. have experienced spectacular growth. The total assets of unit trusts reached £350 million by the end of 1963, showing a net increase of £55 million over the year. The total assets of investment trust companies stood at

English unit trust is the mutual fund or 'open-end' investment company. The distinguishing characteristics of a unit trust, or, to use the American term, a mutual fund, are: (1) the existence of definite arrangements to buy back the outstanding units or shares at a value strictly based on the actual market price of the underlying portfolio of securities, and (2) the offering of further units or shares, continuously or intermittently in blocks, at a price equal to the current asset value of the outstanding units or shares. The trust's portfolio has to be regularly revalued at a particular time each day at the prevailing market prices in order to arrive at the current asset value of the units or shares. The sale price of the units or shares normally includes a loading or service charge, intended to meet the initial distribution expenses. After meeting the periodic management expenses, the income of the trust is divided among the holders of trust's units or shares.

The earlier unit trusts which were formed in the U.K. and the U.S.A. over three decades ago were mostly fixed trusts in which the list of securities forming the investment portfolio was fixed by the trust deed and the management had no discretion to alter the composition of the portfolio except in certain specified circumstances. Experience, however, indicated the need for greater flexibility in the management of investment portfolio and hence nearly all unit trusts formed in later years were flexible trusts allowing considerable managerial discretion.[15]

£2,837 million at the end of 1963, and showed a net increase of £68 million over the year. Thus unit trusts in the U.K. were still far behind investment trust companies, but were growing proportionately more rapidly than the latter. (See *Bank of England Quarterly Bulletin*, Mar. 1964, Tables 19, 20, pp. 67-68.)

On the other hand, in the U.S.A., 'open-end' investment companies, which are the American counterpart of the English unit trusts, predominate overwhelmingly over 'closed-end' investment companies. As at the end of 1959, the net assets of 'open-end' companies totalled \$.15.8 billion and of 'closed-end' companies, \$1.7 billion. (See Investment Company Institute, op. cit., p. 96.)

[15]The amount of discretion which the management is permitted to exercise varies widely from one unit trust to another. See Lord Piercy, 'The Principle of Unit Trust'. in *Principal Memoranda of Evidence Submitted to the Committee on the Working of the Monetary System* (London, 1960). Vol. III, pp. 202-3. The Committee will hereafter be referred to as Radcliffe Committee.

In the U.K., a unit trust invariably takes the form of a properly constituted legal trust. The legal arrangements are lucidly explained in the following quotation:

> The *unit trust* is a trust similar to a will or marriage settlement to which there are three parties: the management company which operates as a distinct entity from the trust it conducts; the trustee, usually a well-known bank or insurance company; and the unit-holders, who occupy the position of beneficiaries under the trust deed. The essential principle of the unit trust is the deposit of a block of Stock Exchange securities with trustees and the sale to the public of ownership fractions (units or sub-units) of this larger block. The management company (with the trustee's co-operation to a lesser or greater degree according to the responsibility undertaken in the trust deed) retains the administration of the securities, but not their custody, which vests in the trustees. This particular basis of operation (the antecedent purchase of securities by the managers as principals and their sale to the unit-holders in their capacity as agents) is applied to some of the fixed and flexible trusts and is known as the 'appropriation' principle. There are, however, a number of unit trusts which operate on the 'cash fund' principle.[16]

The American mutual funds are incorporated as companies. They are referred to as 'open-end' investment companies because they are continuously offering new shares to investors and also stand ready to buy back the shares at any time. Unlike 'closed-end' companies, they do not have a fixed amount of capital.

The unit trusts have greater popular appeal as compared to investment trust companies for several reasons. Perhaps the most important factor is that the unit trust is a perfect technical

[16]C.O. Merriman, *Unit Trusts and How They Work* (2nd edn. London, 1959). pp. 11-12.

In the case of trusts which operate on the 'cash fund' principle, 'the number of units in issue is increased daily by the number of the units sold on account of the trust, and the cash consideration received on account of those sales (less any proportion which is the share of the managers or the Inland Revenue) is added to the trust fund as "cash for investment". Purchases of securities are made out of the cash balance.' Ibid.

device to keep the value of units close to the value of underlying securities and to ensure their liquidity by providing for redemption of units at their asset value at any time, at the option of the unit-holder. On the other hand, the price of shares of an investment trust may fluctuate independently of their asset value. Further, the market for the shares of an investment trust company, particularly if the company is a small one, may be narrow so that ready marketability is not ensured.[17]

Another reason for the greater popular appeal of unit trusts is the simplicity of the arrangements, placing the units within the easy reach of small investors. Units can be bought and sold in relatively small amounts in contrast to the usual round lots in which the shares of investment trust companies are traded on a stock exchange. Further, many investors, not familiar with the stock exchange, would fight shy of undertaking a transaction on the stock exchange and the costs involved for small lots may be substantial. The buying and selling of units requires no direct operation on the stock exchange.

Finally, an important reason for the strides made by the unit trust movement is aggressive selling.

(3) The Unit Trust of India

Although unit trusts have acquired tremendous popularity in the U.K. and the U.S.A. during recent years, they have been conspicuously absent from the Indian financial scene presumably

[17] *Minutes of Evidence*, Radcliffe Committee. See evidence given by the Association of Investment Trusts, Question No. 7466: 'Holder of units in a unit trust can look in the paper every day and see what the price is, and they know they can buy or sell at that advertised price. In the case of our kind of trust [that is, an investment trust company with shares quoted on a stock exchange] the shareholder cannot do that. There are not necessarily dealings in a particular trust every day; and even if there were dealings yesterday, it would not follow that one could come in today and buy or sell the stock, because of the narrowness of the market.'

The Radcliffe Committee observed, 'The peculiar feature of the unit trust, from the point of view of the investor, is the combination of the spread of investment and high marketability. . . . The units themselves can be bought or sold far more freely than shares in investment trust (which have a narrow market) and at prices fluctuating with the value of the trust's portfolio. See Committee's *Report*, p. 96, para. 281.)

because the Indian legal and fiscal system did not recognize them. Only recently a unit trust, known as the Unit Trust of India, has been set up by the Government of India as a public-sector institution.

The Unit Trust of India (UTI) came into existence on 1 February 1964 under the Unit Trust of India Act, 1963. To give a start to the Trust, its initial capital which was statutorily fixed at Rs. 5 crores was contributed by the Reserve Bank of India (Rs. 2.5 crores), the Life Insurance Corporation (Rs. 75 lakhs), the State Bank of India and its subsidiaries (Rs. 75 lakhs), and banks in the private sector and other financial institutions (Rs. 1 crore). As distinct from initial capital is the unit capital which is derived from the sale of units to the public.

The management expenses chargeable against unit capital have been statutorily limited to a maximum of 5 per cent of the gross income allocated to unit capital. At least 90 per cent of the income allocated to unit capital must be distributed by the Trust to unit-holders once every year.

The UTI has been exempted from the payment of any tax on its income. Apart from this exemption, which should be regarded as a necessary requirement for maintaining equity between direct holders of corporate securities and indirect holders through the Trust, a special fiscal inducement has been offered to individuals to invest in units issued by the Trust; the income derived by an individual from the Trust up to Rs. 1,000 will also be exempt from income tax in the hands of the recipient, and will also be excluded from the computation of his total income for purpose of determining the rate of income tax applicable to his other income. No deduction at source is to be made from the income distributed by the Trust.

Under the Unit Trust of India Act, the units have been given a face value which has been fixed by the Trust at Rs. 10 per unit. This is an unnecessary complication. A unit simply represents a participation in the equity of the Trust. Thus if there are, say, 100,000 units, each unit has 1/100,000 share in the income and assets of the Trust. The true nature of unit investment would have been made clearer to investors if they were made to think, not in terms of face value, but in terms of intrinsic or asset value.

The actual sale of units was commenced by the UTI

from 1 July 1964. The sale is conducted through branches of banks and through members of recognized stock exchanges.

An assessment of the UTI as a savings institution requires the examination of two main aspects of its operations: (1) the volume of savings passing through it and (2) its investment policy.

The importance of the UTI as a savings institution depends on the amount of savings that it is able to attract, that is, on the amount of its net sales of units. It is too early to form a considered judgment of the UTI's role in the mobilization of savings for industrial investment. The emergence of this new medium of holding savings might have led many people to convert their past savings held as fixed or savings bank deposits or in other forms into units of the UTI. This is indicated by the fact that out of the UTI's net sales of Rs. 18.7 crores during the first year of its operations, sales during the initial period from 1 July to 14 August 1964, when units were sold at face value, amounted to Rs. 17.4 crores (excluding the initial capital of the UTI), the monthly average of sales during the remaining part of the year being only about Rs. 13 lakhs. The outbreak of Indo-Pakistan hostilities and the worsening economic situation brought down the net sales of units during the second year of the UTI's operations to an average of Rs. 9 lakhs per month only. Thus, while sales during the initial period presented an encouraging picture and raised high hopes, sales in the subsequent period have been disappointing. Net sales of units during the year 1966-67 show a substantial rise to Rs. 7.25 crores.[18]

Before the creation of the UTI, the Life Insurance Corporation was the only important institutional buyer of industrial securities in India. The setting up of the UTI has added a new source of institutional demand for industrial securities which is likely to become important in the future.

As regards the UTI's investment policy, it is declared to be a balanced fund, investing in both equity and fixed-income securities. Its policy is in general conservative; the place

[18]See UTI, *Third Annual Report*.

accorded to equities in its portfolio is relatively small.[19] Its investment regulations lay down that not more than 5 per cent of the investible funds shall be invested in the initial issues of new industrial undertakings. It seems to place primary emphasis on securing a reasonably high current income as opposed to capital appreciation; its declared policy is to invest in securities yielding an over-all return of over 6 per cent per annum.[20]

The UTI, like the LIC, is a monolithic institution. Considerations which lead the LIC to prefer the large and established company seem to operate even more forcefully in the case of the UTI. A factor which tends to give a sharper edge to the UTI's preference of the large firm is that the UTI's investments have to be valued daily in order to determine the sale and repurchase prices of its units. This consideration more or less rules out investment by the UTI in unquoted securities; even inactively traded securities become a rather undesirable form of holding for the UTI. Hence the investments of the UTI are likely to be confined to a somewhat narrower range of industrial securities than those of the LIC.

(4) Some Policy Issues

This section attempts to examine how far the structure chosen for this new savings institution in India can be regarded as appropriate.

[19]The total investments of the UTI were distributed as follows as on 30 June 1967:

	Rs. crores	*Per cent*
Equity shares	14.0	41.2
Preference shares	4.0	11.8
Debentures	13.9	41.2
Bonds of public corporations	0.7	2.2
Advance deposits and application money for purchase of debentures and preference shares	0.7	2.1
Treasury bills	0.5	1.5
Total	33.8	100.0

Source: UTI, *Third Annual Report.*

[20]See the offer for sale of units advertised by the UTI, *The Statesman*, 30 June 1964.

The first important feature of this structure is that it consists exclusively of the unit trust variety. The second variety, viz. the investment trust company, is not expressly prohibited but is more or less doomed because of fiscal discrimination and lack of encouragement.

There is no doubt that the unit trust has greater popular appeal than the investment trust company. But its usefulness from the viewpoint of promoting industrial growth in a newly industrializing economy is strictly limited because of severe constraints on its investment policy. As already pointed out, the need for daily valuation of units results in restricting the field of its investment to a relatively narrow range of scrips, viz., those which are actively traded on the market. On the other hand, investment trust companies, even if conservatively managed, can reasonably operate over a much wider area of corporate securities. Some investment trust companies may even specialize in the smaller and less actively traded scrips.

In this connection, it may be noted that only a small proportion of the industrial securities quoted on the Indian stock exchanges is actively traded and can be regarded as eligible for holding by a unit trust. Some idea of trading continuity on the Bombay and Calcutta stock exchanges can be had from Table 24.3 which shows a distribution of listed issues between traded and not-traded issues according to the length of the period which had elapsed between the date of the transaction and the selected trading day.

Table 24.3 shows that of 373 equity issues listed on the Bombay Stock Exchange, only 132 were traded on the selected day (18 May 1962). Nearly half of the number of listed issues had not been traded for periods varying from over a week to more than a year. Trading on the Calcutta Stock Exchange is even more restricted.[21] Of the 611 equity issues listed on the Calcutta Stock Exchange, only 80 were traded on the selected day and about two-thirds of the issues had not been traded for more than a week.[22] A unit trust in these circumstances will

[21]The reason for this is the preponderance of small companies among the companies listed on the Calcutta Stock Exchange.

[22]Preference and debenture issues are normally traded less frequently than equity issues but on that account they do not raise the same awkward problems as the latter.

have to operate on a rather narrow fringe of the industrial securities market.

Investment trust companies can operate over a wider part of the industrial securities market[23] and can facilitate even private placing[24] of small issues. They offer perhaps the only practical solution to the problem of finding equity capital for small companies, whose securities can have no ready marketability. If the benefits of institutional investment are to be extended over as large a part of the industrial securities market

TABLE 24.3
TRADING CONTINUITY ON BOMBAY AND CALCUTTA STOCK EXCHANGES

	Bombay stock exchange	*Calcutta stock exchange*
Number of listed equity issues traded on the selected trading day (18 May 1962)	132	80
Number of issues not-traded on the selected day	241	531
Total number of listed equity issues	373	611
Distribution of not-traded issues according to the length of the period elapsed between the date of the last transaction and the selected day:		
Up to 1 week	60	123
Over 1 week up to 1 month	45	129
Over 1 month up to 3 months	41	80
Over 3 months up to 6 months	25	72
Over 6 months up to 1 year	19	66
Over 1 year	51	61
Total of not-traded issues	241	531

Source: Compiled from the daily Quotation List published by the Bombay and Calcutta stock exchanges. Where the quotation list showed more than one issue of the same company but with different amounts paid-up on each, they have been treated as one issue for the purpose of the above analysis.

[23]This subtle point seems to have found recognition in at least one important report. See O.E.E.C., *The Supply of Capital Funds for Industrial Development in Europe*, Paris, 1957, p. 78.

[24]*Minutes of Evidence*, Radcliffe Committee; evidence given by the Association of Investment Trusts, Question No. 7478.

as possible, the investment trust company deserves as much encouragement as the unit trust.

In a nutshell one might say that while the unit trust because of its popular appeal is a more effective instrument for the collection of savings, the investment trust company because of its freedom from certain constraints can be more effective in promoting the developmental uses of available funds. The best policy, therefore, will be to have both, and to interlock them in such a fashion that a portion of unit trust funds are invested through investment trust companies. This kind of inter-institutional transfer of funds is a common feature of developed capital markets and can serve as a useful technique for promoting the uses of available funds more in accordance with development needs.

The second feature of the pattern envisaged for the development of this relatively new savings institution in India is the choice of a monolithic structure and a lack of variety of investment plans to be offered to savers.

There is wide scope within the field of industrial securities to follow different investment objectives, involving varying degrees of emphasis on current income and future growth. Investment trusts in the U.K. and the U.S.A. exhibit a variety of investment objectives. Each investment trust tries to satisfy in the largest possible measure the special needs of a particular class of investors. Thus, some trusts aim at giving the highest possible current yield and have a special appeal for people whose need is for current income, for instance, widows and retired persons. Others place primary emphasis on long-term growth prospects and chances of capital appreciation, and appeal most to those who want to build up a capital fund. The difference in emphasis on current income and future growth is reflected in the difference in starting yields on the units offered. An examination of a number of unit trust offers made during the year 1963 in the U.K.,[25] for instance, showed that the current gross yield on the units offered varied from £2. 10*s*. 2*d*. per cent to £5. 0*s*. 7*d*. per cent.[26]

[25]The examination was made on the basis of unit trust offers published in *The Observer* from time to time.

[26]Names of some unit trusts suggest whether the emphasis is on current income or on future growth. Some examples are: Allied High

Investment trusts may specialize by industry also. It is not entirely correct to say that specialization is inconsistent with the principle of investment trusts. Investment trusts are basically a device to pool risks but the area of such pooling can vary depending on the object in view. Risks can be pooled among firms within the same country or region, among different geographical regions, or among different types of securities. There are many instances of such specialized investment trusts in the U. K. as the following names will suggest—Bank-Units, Insurance-Units, Natbifs (that is, National Banking Insurance, and Financial Shares Trust), Property Share Units Trust, Investment-Trust-Units, Domestic Shopping Basket Unit Fund, Electrical and Industrial Development Trust, Leisure Unit Trust (to invest in industries related to leisure spending of Britons), etc.

Thus the diversity of investment objectives is an important characteristic of the investment trust movement in both the U.K. and the U.S.A.[27] The spectacular success achieved by the

Income Unit Trust, Income-Units, Capital-Units. The latter two belong to the same management group. An offer by Income-Units made in November 1963 showed an estimated starting yield of £4. 16*s*. 6*d*. per cent while an offer by Capital-Units in Oct. 1963 showed an estimated yield of £3. 1*s*. 6*d*. per cent only. Further the Capital-Units also offered a Monthly Investment Plan and a Children's Gift Plan. Under the former an investor can make regular monthly investment in Capital-Units and the income earned on the units is automatically re-invested. Under the latter plan, an investor can make a kind of endowment for his children. His investment (minimum £100) will be held in trust until the child reaches a certain age, and the income from the units bought will be regularly re-invested.

[27]A recent study of the American mutual funds by Investment Company Institute (op. cit., p. 23) classified them into the following groups according to portfolio composition and investment objectives:

Portfolio composition	*No. of companies*
1. Balanced (Bond, Preferred and Common Stocks)	53
2. Common Stock Funds	63
3. Industry Fund—Balanced	1
4. Industry Fund—Common Stocks	10
5. U.S. Regional Investment Funds	5
6. Canadian Investment Funds	5
7. Industry or Objective Series	11
Total	148

investment trust movement in these countries, is in no small measure due to this variety, indicating an aggressive search for what will best serve and find acceptance with investors. The Unit Trust of India Act, 1963, did not originally provide for a variety of investment plans. The Act was amended in early 1966 to enable the Trust to organize a variety of unit schemes by creating separate funds. The amendment also authorizes the UTI to offer savings-cum-insurance plans and other savings plans like the Children's Gift Plan. Such plans are being formulated by the Trust. The Trust has already started from 1966 to give the facility of re-investment of income to unit holders.

It should also be considered whether it would not be better to have several unit trusts of moderate size instead of a single large one. From the viewpoint of securing the best results for investors, a fund of moderate size seems to be preferable to a relatively large one. This is because effective supervision and active management of the portfolio becomes well-nigh impossible when the fund has grown beyond a certain size. The introduction of an element of competition will also act as a spur to greater efficiency resulting in better service to unit holders.

(5) Concluding Observations

In contrast to most other organized savings institutions, whose obligations are fixed in money terms, investment trusts in general, and investment trust companies in particular, are a highly versatile savings institution. This is as yet an underdeveloped segment of India's financial institutions. In order to satisfy the rising financial needs of private industry the demand

Major investment objectives	*No. of companies*
1. Capital Growth	34
2. Capital Growth and Income Growth	20
3. Capital Growth and Current Income	45
4. Current Income	9
5. Capital Preservation	2
6. Capital Preservation and Capital Growth	4
7. Capital Preservation and Current Income	7
8. Capital Growth, Current Income and Capital Preservation	16
9. Various (Series of Funds)	11
Total	148

for industrial securities must continue to increase. Investment trusts constitute one of the most effective instruments for achieving this objective. The future policy should aim at building up a decentralized and diversified structure of investment trusts.

POSTSCRIPT

THE UNIT TRUST OF INDIA AND THE INDUSTRIAL SECURITIES MARKET

Before the establishment of the Unit Trust of India in 1964, the Life Insurance Corporation of India, which came into existence in 1955 as a result of nationalisation of the life insurance business, was by far the most dominant institutional buyer of industrial securities in India. Over the decade since the UTI opened its doors, its net purchaser of industrial securities have substantially exceeded those of the LIC, the respective totals for the ten years upto 1974 being Rs. 147 crores and Rs. 98 crores (see Table 24.4). The UTI now ranks as the largest buyer of industrial securities and the LIC has been relegated to a second place.

It is curious to note that the LIC's interest in industrial securities has significantly declined after the entry of the UTI in this market. The LIC's annual purchases of industrial securities during 1962-63 to 1965-66 ranged between Rs. 15-24 crores but in the subsequent years such purchases were only between Rs. 5-10 crores. Seen against the steady growth of life insurance funds, this is particularly striking. While upto 1965-66, the LIC invested, on an average, about 15-16 per cent of the annual additions to its life fund in industrial securities, the proportion fell to 7 per cent during 1966-68 and declined further to just 2-3 per cent during 1971-74. The result is that the holdings of corporate securities, which formed 16.5 per cent of the LIC's total assets in 1966, formed just 8.4 per cent of its assets in 1974. It may be said that the industrial securities market in India was not big enough, and has not been growing fast enough, in terms of availability of good industrial securities, to be able to support two such big investing institutions. Both the LIC and the UTI have been generally complaining of the paucity of good corporate securities for acquisition by them.

TABLE 24.4

NET ANNUAL PURCHASES OF INDUSTRIAL SECURITIES BY THE UTI AND THE LIC, 1964-65 TO 1973-74

(Rs. crores)

Year*	UTI				LIC†			
	Equity	*Pref.*	*Deb.*	*Total*	*Equity*	*Pref.*	*Deb.*	*Total*
1964-65	9.6	1.9	9.3	20.8	8.8	1.4	5.5	15.7
1965-66	1.1	0.6	1.6	3.3	20.7	2.9	0.1	23.7
1966-67	3.3	1.5	3.0	7.8	4.4	2.5	2.8	9.7
1967-68	4.7	3.7	6.0	14.4	4.3	1.8	3.8	9.9
1968-69	5.3	1.6	7.0	13.9	2.7	1.2	3.3	7.2
1969-70	7.6	2.6	10.3	20.5	2.9	0.9	2.1	5.9
1970-71	8.1	1.2	3.7	13.0	3.2	1.2	−2.1	2.3
1971-72	4.9	0.8	1.0	6.7	4.0	1.3	3.3	8.6
1972-73	16.1	1.0	6.2	23.3	2.2	1.4	4.1	7.7
1973-74	17.2	1.5	5.1	23.8	4.0	1.1	2.5	7.6
Total	77.9	16.4	53.2	147.5	57.2	15.7	25.4	98.3
Percentage of different classes of corporate securities purchased during 1964-74	52.8%	11.1%	36.1%	100.0%	58.2%	16.0%	25.8%	100.0%
Total holdings of corporate securities as in 1974‡ (Rs. crores)	77.9	16.4	53.2	147.5	134.2	39.8	63.3	237.3
Percentage of different classes of corporate securities held as of 1974	52.8%	11.1%	36.1%	100.0%	56.5%	16.8%	26.7%	100.0%

*The data relate to the accounting years, i.e., July-June for the UTI and April-March for the LIC. Hence the annual data are not strictly comparable between the LIC and the UTI.

†Pertaining to life business only and covering only holdings in Indian companies.

‡As at the end of the accounting year of the respective institutions.

Source: Annual Reports of the UTI and the LIC.

Because of the substantially reduced purchases of industrial securities by the LIC after the creation of the UTI, the aggregate institutional purchases of such securities by these two institutions together have not shown a significant rise between 1964-65 and 1973-74 (see Table 24.4). In a sense, the setting up of the UTI can be said to have relieved the LIC of a responsibility to support the industrial securities market. This has enabled LIC to go rather heavily into the financing of housing and other schemes of state governments, statutory authorities, cooperatives and electricity boards.

Of course, as a savings institution, the LIC far outweighs

TABLE 24.5

NET ANNUAL ADDITIONS TO THE FUNDS OF THE LIC AND THE UTI, 1964-65 to 1973-74

(*Rs. crores*)

Year	*LIC*	*UTI*
1964-65	98.2	23.7*
1965-66	107.9	1.1
1966-67	133.3	7.3
1967-68	141.0	14.1
1968-69	160.9	15.5
1969-70	179.4	20.8
1970-71	213.0	14.8
1971-72	241.5	12.5
1972-73	290.5	20.1
1973-74	348.8	26.6
Total addition to investible funds	1914.5	156.5
Of which, invested in industrial securities	98.3	147.5

*Including the initial capital of Rs. 5 crores provided by the Reserve Bank, the LIC and the commercial banks.

Note: In the case of the LIC, the net annual addition to its funds is represented by the net annual increase in the balance of the Life Fund pertaining to business in India only. Transfer out of Life Fund to the Investment Reserve Account during any year has been added back to the Life Fund for the purpose of this table. In the case of the UTI, the net annual addition to its funds is represented by the net annual sales of units, i.e., gross sales less the repurchases.

Source: Annual Reports of the LIC and the UTI.

the UTI and the LIC's funds have shown a steady and impressive growth (see Table 24.5). The net addition to the LIC's funds over the ten years 1964-65 to 1973-74 was about twelve times the amount mobilised by the UTI. However, only a small fraction of the LIC's funds are channelled into industrial investment while the UTI is entirely in the business of investing in industrial securities. The net addition to the UTI's funds have shown rather wide fluctuations from year to year, as may be seen from Table 24.5.

At present, the LIC still occupies a dominant position as the holder of industrial securities even though its fresh purchases of such securities have sharply fallen since 1966. The total accumulation of industrial securities in the hands of the LIC in 1974 was a little over one and a half times that in the UTI's hands (see last but one row of Table 24.4). However, given the present trends, the UTI bids fare to overtake the LIC in the next few years as having the largest concentration of industrial securities in a single hand.

APPENDIX

TABLE A 24.6

INVESTMENT PATTERN OF INVESTMENT TRUST COMPANIES IN INDIA, 1961-62

(Rs. lakhs)

Name of the company	*Investments at book value*			*Equity shares*	*Preference shares*	*Debentures*	*Indian Govt. stocks*
	Quoted	*Unquoted*	*Total*				
1. General Inv. Trust Ltd.	6.70 (7.63)	1.94	8.64	5.93	2.41	0.30	Nil
2. Industrial Inv. Trust Ltd.	123.14 (157.04)	20.32	143.47	108.12	21.37	13.87*	0.11
3. Inv. Corp. of India Ltd.	297.88 (338.07)	219.85‡	517.73	482.72	34.61	0.40†	Nil
4. Kishore Trading Co. Ltd.	53.96** (53.96)	—	53.96	47.96	6.00	Nil	Nil
5. New India Inv. Corp. Ltd.	44.66 (57.63)	0.55	45.21	41.96	0.77	1.74	0.73
6. Oriental Ind. Inv. Corp. Ltd.	77.67 (95.72)	0.92	78.59	70.92	5.41	2.25	Nil
7. Birds Inv. Ltd.	60.57 (80.47)	7.38	67.95	58.29	8.55	1.11	Nil
8. Inv. Trust of India Ltd.	12.67 (14.24)	Nil	12.67	11.80	0.82	Nil	0.05
9. General Investment & Trust Co. Ltd.	4.89 (6.47)	0.17	5.06	4.68	0.35	0.03	Nil
10. Inv. and Finance Co. Ltd.	10.94 (15.38)	0.17	11.11	10.61	0.45	0.05	Nil
Total	693.08 (826.61)	251.30	944.39	842.99	80.74	19.75	0.89

Note: Figures within brackets represent market value.

*Includes Foreign Govt. Stocks Rs. 2.83 lakhs.

†Includes Foreign Govt. Stocks Rs. 0.11 lakhs.

**Breakdown between quoted and unquoted not available. Shown under quoted.

‡Investments in foreign enterprises which are not quoted on Indian stock exchanges are shown under unquoted. Foreign securities included under unquoted investments amounted to Rs. 59.51 lakhs.

TABLE A 24.7

CAPITAL STRUCTURE OF INVESTMENT TRUST COMPANIES IN INDIA, 1961-62

(Rs. lakhs)

Name of company	*Paid-up share capital*			*Debenture*	*Bank loans*	*Other loans and deposits*
	Equity	*Preference*	*Total*			
1. General Inv. Trust Ltd.	5.53	Nil	5.53	Nil	2.96	Nil
2. Industrial Inv. Trust Ltd.	99.99	Nil	99.99	Nil	17.14	Nil
3. Inv. Corp. of India Ltd.	170.22	50.00	220.22	80.00	40.92	16.86
4. Kishore Trading Co. Ltd.	20.00	Nil	20.00	Nil	8.45	Nil
5. New India Inv. Corp. Ltd.	23.32	Nil	23.32	Nil	5.48	Nil
6. Oriental Industrial Inv. Corp. Ltd.	45.72	18.17	63.89	Nil	0.05	0.01
7. Birds Inv. Ltd.	20.00	24.00	44.00	Nil	12.82	Nil
8. Inv. Trust of India Ltd.	10.00	Nil	10.00	Nil	Nil	Nil
9. General Inv. and Trust Co. Ltd.	2.25	2.00	4.25	Nil	0.38	Nil
10. Inv. and Finance Co. Ltd.	5.00	4.00	9.00	Nil	Nil	Nil
Total	402.03	98.17	500.20	80.00	88.20	16.87

TABLE A 24.8

SOME OPERATIONAL ASPECTS OF INVESTMENT TRUST COMPANIES IN INDIA, 1961-62

Name of the company	*System of management*	*Gross yield on portfolio** (%)	*Estb. charges as % of total investment*†	*Gross equity dividend paid last year* (%)
1. General Inv. Trust Ltd.	Directors	7.11	1.0	7.0
2. Industrial Inv. Trust Ltd.	Directors**	6.53	0.7	6.5
3. Inv. Corp. of India Ltd.	Directors	7.57	1.1	9.5‡
4. Kishore Trading Co. Ltd.	Directors	6.27	0.5	8.5
5. New India Inv. Corp. Ltd.	Secretaries and Treasurers	N.A.	1.3	6.5
6. Oriental Ind. Inv. Corp. Ltd.	Managing Agents	7.96	1.4	5.5
7. Birds Inv. Ltd.	Secretaries	4.51	0.3	10.0
8. Inv. Trust of India Ltd.	Managing Agents	5.64	1.7	6.0
9. General Inv. & Trust Co. Ltd.	Secretaries	5.64	2.4	5.0
10. Inv. and Finance Co. Ltd.	Secretaries	5.67	1.6	7.5

*Valuing quoted investments at market value and unquoted investments at book value and excluding realized capital gains from investment income. Tax deducted at source from income has been added back to arrive at gross yields.

†Valuing investments in the same manner as for the purpose of calculating gross yield. Establishment charges exclude interest payable on borrowings and income tax.

**Since the beginning of 1962. Up to the end of 1961, the company was managed by Secretaries and Treasurers.

‡Including Silver Jubilee bonus of 1 per cent.

TABLE A 24.9

GROWTH IN PAID-UP CAPITAL AND INVESTMENTS OF INVESTMENT TRUST COMPANIES IN INDIA, 1955-57–1961-62

(Rs. lakhs)

Name of the company	Share capital: Present paid-up capital*	Share capital: Increase (+) or decrease (—) over last five years	Investments: Present book-value of investments*	Investments: Increase(+) or decrease (—) over last five years
1. General Inv. Trust Ltd.	5.53	+0.01	8.64	—2.87
2. Industrial Inv. Trust Ltd.	99.99	Nil	143.67	+20.87
3. Inv. Corp. of India Ltd.	220.22	+95.22	517.73	+176.76
4. Kishore Trading Co. Ltd.	20.00	Nil	53.96	—1.01
5. New India Inv. Corp. Ltd.	23.31	Nil	45.21	+11.22
6. Oriental Ind. Inv. Corp. Ltd.	63.89	Nil	78.59	+8.98
7. Birds Inv. Ltd.	44.00	Nil	67.95	+0.76
8. Inv. Trust of India Ltd.	10.00	Nil	12.67	+1.97
9. General Inv. & Trust Co. Ltd.	4.25	Nil	5.06	—0.41
10. Inv. and Finance Co. Ltd.	9.00	Nil	11.11	—2.16
Total	500.20	+95.23	944.39	+214.11

*The figures relate generally to 1961-62.

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Some Aspects of Foreign Investment Policy*

S.S. Tarapore

This essay examines the various issues of policy concerning foreign private investment. It discusses the direct and indirect costs and benefits of such investment, particularly the effect on the host country's balance of payments.

Editor

This article falls broadly into four sections. The first section provides a brief survey of the literature on the costs and benefits of foreign private investment from the stand point of both the capital exporting and host countries. While the classical view encouraged foreign investment on the ground that it raised the efficiency domestic capital, the more modern analysis is inclined to consider foreign investment as of limited use to the capital exporting country; also, doubts are cast on the benefit of foreign investment to the host country in view of the resulting balance of payments strains. The second section attempts a critical examination of the concept of the 'rate of return' on foreign investment and considers its significance in attracting foreign capital. The third section deals with the relative merits of foreign loans and foreign equity *vis-à-vis* their impact on balance of payments and the concluding section contains some observations on foreign investment policy in India.

*Taken from the *Reserve Bank of India Bulletin,* May 1966, pp. 508-17. Reprinted by permission.

Foreign Private Investment: The Cost-Benefit Analysis

The costs and benefits of foreign private investment have to be viewed from the stand point of both capital exporting and host countries; again, the costs and benefits as assessed from the viewpoint of the firm (as a unit) and the nation (as a whole) may diverge. The conclusions drawn by economic analysis on the costs and benefits of foreign private investment are often equivocal and being based on very restrictive assumptions, are of limited use from a policy angle. Nevertheless, under certain conditions, the analysis does throw up some policy pointers for host and exporting countries. An attempt is made in this section to survey, in brief, the literature on the costs and benefits of foreign private investment from the view point of both exporting and host countries.

From the capital exporting country's viewpoint, foreign investment represents an increase in exports, without a corresponding increase in imports, in order to secure an ultimate increase in imports. The classical view was that foreign private investment was a factor working towards increasing the efficiency of domestic investments.[1] This contrasts with the Keynesian views that in so far as capital is complementary with other factors some of the national advantages, from the use of capital, are lost when capital is exported. It is argued, moreover, that comparison of the rate of return on domestic investment with that on foreign investment is an inappropriate guide for allocation of investment, from the *national* interest, since the risk effect is different as between home and foreign investment. Domestic risks to the private investor are not risks to the nation whereas similar risks abroad are shared by the private investor and his nation.[2] It is argued

[1]'The exportation of capital is an agent of great efficiency in extending the field of employment of that which remains—and it may be said truly that up to a certain point, the more capital we send away, the more we shall possess and be able to retain at home'—J. S. Mill quoted by C.K. Hobson 'The Export of Capital' (1914).

[2]'If the Grand Trunk Railway of Canada fails its shareholders we have nothing. If the Underground System of London fails its shareholders, Londoners still have their Underground System'—J.M. Keynes quoted by J.C. Murphy 'International Investment and the National Interest' *Southern Economic Journal*, July 1960.

that unless direct and indirect yields of foreign investment are very high, there is some presumption that from a national point of view, domestic investment is preferable at the margin.[3] The Keynesian approach leading away from private foreign investment is reflected in the periodic measures undertaken by the leading capital exporting countries to curb private foreign investment in order to correct balance of payments deficits. The flow of capital to developing countries has sometimes been exempt from these curbs not because of a belief that the return on investment in these countries is higher than in other parts of the world, but because of certain non-economic policy decisions which necessitate the encouragement of capital flows to the developing countries. In this context, the need for highlighting the classical analysis in the present context cannot be exaggerated.[4]

The case against foreign investment by capital exporting countries may be briefly stated. Enterprises should invest in whatever line of activity, in whatever region affords the largest return. Foreign investment can be advocated only if the return is greater than that on domestic investment after allowing for the differences in risk and the foregoing of benefits in terms of returns on complementary domestic factors like labour. Under assumptions of perfect competition and invariant terms of trade, the marginal social productivity of foreign investment will be less than that on home investment. However, foreign investment is more likely than not to change the terms of trade effect and since the terms of trade effect cannot be determined, *a priori* presumptions regarding the relative merits of investment at home and abroad are not warranted.[5] Once the

[3]T. Balogh and P.P. Streeton 'Domestic Versus Foreign Investment' *Bulletin of the Oxford University Institute of Statistics*, August 1960.

[4]'We certainly need a Hobson or a Mill today, when so many opportunities are missed in the periods during which the Treasury clamps on its restrictions and when in some, although not in all, respects a greater out-flow of capital could be more fruitful in helping the developing countries of the world than it could be half a century ago.' R. Harrod in the Preface to C.K. Hobson 'The Export of Capital' (1963 Edition).

[5]G.D.A. MacDougall 'The Benefits and Costs of Private Investment from Abroad: A Theoretical Approach', *Economic Record*, March 1960.

restrictive assumptions of perfect competition and invariant terms of trade are relaxed, the case for home *versus* foreign investment depends on the industries and conditions under which the investment is undertaken. Moreover, it is not as if there is clear-cut choice between investment at home and investment abroad; under certain conditions the choice may be between investment abroad and consumption at home, in which case the opportunity cost of the foreign investment is zero and any return on foreign investment a gratuity.[6]

The typical growth sequence of foreign investment in a developing economy is through portfolio investment, in the form of government overseas borrowing for infrastructural facilities, followed by direct investment in extractive and agricultural industries with an export bias; subsequent to this stage there is the development of direct investment in manufacturing in an inflationary context. Present day foreign investment is often criticised because of the balance of payments problems created by such investments in the host countries. The deterioration of the host country's balance of payments is not a necessary corollary of increased foreign investment since much depends on the orientation of this investment. The higher investment income liabilities might be offset by capital inflows and favourable effects on the current balance through export stimulation and import saving. However, a pattern of investment which is import-creating or export-discouraging is likely to aggravate the payments problem. Though a capital inflow by itself is deflationary, the investment might increase the domestic demand for imports and exportables; again, the foreign investment may encourage complementary investment and thereby create an inflationary gap.[7] The relationship between fresh capital inflows (net of repatriation) and remitted profits is an index of the net effect on the current foreign exchange position and that between total profits and export income an index of the long-term strain of the debt burden on the balance of payments. In the case of direct investment, the benefits in terms of increased production in sectors where domestic technical and managerial

[6]M. Frankel 'Home Versus Foreign Investment: A Case Against Capital Export', *Kyklos* Fasc 3, 1965.

[7]H.W. Arndt 'Overseas Borrowing the New Model', *The Economic Record*, August 1957.

skills are not forthcoming may far outweigh the direct costs in terms of the repatriation of profits. Though the indirect benefits, which cannot be quantified, accrue currently, the indirect costs are mainly deferred and some of these, like increased foreign control, inflation and long-term balance of payments adjustment, may not even be suspect.[8] While traditional direct investment in extractive/agricultural sectors had a sufficient export bias, the New Model[9] direct investment, moving away from export industry, may create balance of payments liabilities, even apart from problems of repatriation of capital or remittance of profit, by creating a heavy demand for imports. The desire to accelerate capital formation in underdeveloped countries tends to minimise the ultimate problem of servicing foreign capital, and the initial balance of payments pressure tends to be eased to the extent that substantial proportion of profits is retained;[10] however, this increases the future earnings on foreign investment and a stage is invariably reached where the rate of increase in foreign investment is less than the rate of earnings. Hence foreign capital can grow without any net import of foreign exchange. Again, after a few years, the indirect benefit in terms of import of know-how and managerial skills tapers off with the ageing of the investment and there is a good case for developing economies buying out foreign investment in such sectors where foreign investment liability grows disproportionately to the benefits.[11] This might be justified even if it were necessary to borrow funds abroad for such purchases.[12] The easing out of foreign investment from such sectors is essential since indefinite retention of profits is not possible. Insofar as curbs on expansion in 'self-generating' sectors have not been imposed, the foreign debt problem has often enough, in the past, been solved by default or moratoria

[8]H.W. Arndt, ibid.

[9]H.W. Arndt, ibid.

[10]The question of retained earnings is discussed in some detail in Section II.

[11]E.T. Penrose 'Foreign Investment and the Growth of the Firm', *The Economic Journal*, June 1956.

[12]D.A. Wells 'Economic Analysis of Attitudes of Host Countries Towards Direct Private Investment' in R.F. Mikesell' *U.S. Private* and *Government Investment Abroad* (1962).

or restrictions on transfer of investment income. It is argued, for instance, that allowance is made for such risks in the investment decisions by foreigners.[13] However, the adverse impact on the flow of fresh investment may be much smaller if policy measures are taken to ensure against excessive expansion by way of retained earnings by foreign controlled units in well-developed fields of industry. Not only would the adverse effect be lower but, conceivably, the balance of payments pressure may also be minimised.

THE RATE OF RETURN ON FOREIGN PRIVATE INVESTMENT

As mentioned in the earlier section, it is argued that foreign private investment, to be attractive to the exporting country, should yield a return substantially above that on domestic investment. It is claimed, for instance, that to match the social marginal product from domestic investment, foreign investment would need to earn a return equal to 250 per cent of what domestic investment would earn.[14] Since actual rates of return on foreign investment are not substantially higher than those on domestic investment, it is suggested that there is a case against capital export.[15] An attempt is made in this section to examine this proposition and to focus critical attention on the concept of 'the rate of return'.

The rate of return is a somewhat nebulous concept and has been utilised to support widely varying theses. The rate of return often relates to the ratio of net profit after tax to net worth, dividends to paid-up capital or net worth, and gross profits to total capital employed. It is, however, not uncommon in current literature to use imcomparable sets of ratios to support the claim that the rate of return in a particular country or industry is too high or too low.

One of the frequently used ratio is that of net profit after tax to net worth. As indicated in the table below, the average rate of return in India on U.K. and U.S. investment is marginally higher than the average for all countries and the

[13]H.W. Arndt, op. cit.
[14]M. Frankel, op. cit.
[15]M. Frankel, ibid.

average on domestic investment in the U.K. and the U.S. However, the yields are insufficiently high to cover the loss of yields on complementary factors (which would accrue to the investing country if the investment were made at home) as also the special risks of foreign investment. Even so, in actual practice, given adequate information about available opportunities, many kinds of private investment tend to move abroad in response to profit margins which are not substantially above domestic margins.[16] With the increase in the number of countries with available exportable funds, there is likely to be a secular reduction in the cost of international investment and hence it is possible to envisage a step-up in private capital flows without any major alterations in the rate of return.

COMPARATIVE RATES OF RETURN ON U.K. AND U.S. INVESTMENT IN INDIA AND THE WORLD (1958-62 AVERAGE) (Per cent)

Country of Investment	*Investing Country* *U.K.*	*U.S.A.*
India	8.8	11.9
All Countries	7.9	10.2
Domestic	7.8	9.1

Note: The U.K. ratios relate to net income to net asset while those for the U.S. relate to net income to net worth.

Source: J.H. Dunning and D.C. Rowan 'British Direct Investment in Western Europe', *Banca Nazionale del Lavoro,* June 1965.

The literature on foreign private investment is replete with instances of very high profitability, what Latin American economists call the 'decapitalisation' of their countries.[17] Instances equally abound of foreign companies trying to spread the idea that their local activities are barely worthwhile and are kept going on grounds other than business strategy. Many of the prices used by companies are notional because transactions are between departments or close associates. The allocation of overhead

[16]B. Manning, 'Private Foreign Investment: Some Dead Horses and a Live One', in A. Winsemius and J.A. Pincus, *Method of Industrial Development with Special Reference to Less Developed Areas,* OECD (1962).

[17]R. Vernon, 'Saints and Sinners in Foreign Investment', *Harvard Business Review,* May/June 1963.

expenditure of the head office between branches gives sufficient scope for adjusting profits in different countries.[18] For instance, the oil companies complex offers an ideal background for adjusting profits between various stages of operation. It is possible to price crude oil high into the refinery or refined products low out of the refinery so that the refinery realises a lower profit, or price crude low and realise a large profit in the refinery; thus the profit can be realised on the crude end of the business, on the refining or, in the marketing. Hence, it is important to consider an overall return rather than returns on individual segments of an integrated operation.[19]

Apart from the notional rate of return, as reflected in various ratios, foreign investment has other beneficial effects which are not reflected in quantitative rates of return. To circumvent protection granted to nascent industries foreign companies ineluctably shift their line of activity from mere selling to assembly and subsequently to complete domestic manufacture. Expansion of foreign investment of this type is not without benefit to the investing country. The protection of industry gives an ideal setting for the foreign companies to reap lucrative returns. Besides, the operation of foreign affiliates offers a strong stimulus to the export activities of the parent

U.S. EXPORTS TO INDIAN AFFILIATES IN 1962 AND 1963

U.S. $ million

Type of Exports	*Year*	
	1962	*1963*
(1) Materials and Components for Processing/Assembly	23	20
(2) Items for Resale without manufacture ..	83	79
(3) Capital Equipment	18	16
(4) Other Exports	24	10
Total ..	148	125

Source: S. Pizer and F. Cutter, 'U.S. Trade with Foreign Affiliates of U.S. Firms', Survey of Current Business, December 1964.

[18] D. Seers, 'Big Companies and Small Countries: A Practical Proposal', *Kyklos*, Fasc. 4, 1963.

[19] E.R. Barlow and I.T. Wender, *Foreign Investment and Taxation* (1955).

company. For instance, a fourth of U.S. exports of manufactures and semi-manufactures of about $14 billion per annum, are to foreign affiliates of U.S. companies.

The value of U.S. exports to affiliates in India should be considered in relation to the level of outstanding U.S. direct investments in India of a little over $200 million, i.e., the value of U.S. annual exports to affiliates in India is equal to well over two-thirds the outstanding level of U.S. foreign investment in India. The value of exports would be even higher if exports to affiliates by units other than parent companies are included.

Another important aspect of the rate of return is the failure to distinguish between fresh inflows and retained earnings. The pre-requisites for a fresh inflow are very different from those for retained earnings and the risk factors in the two types of investment are in no way identical. Again, as pointed out earlier, the recipient country does not benefit to the same extent from retained earnings as from fresh inflows and foreign investment liabilities of a country may sometimes increase even while there is a net out-flow of capital. The growth of foreign investment by retained earnings is subject to different influences from those determining the fresh inflow of foreign investment and the analysis of retained earnings is more within the sphere of the theory of the firm rather than the general theory of foreign investment.[20] Once a subsidiary is established, expansion is more a function of the firm's innovative capacity and technical and managerial skill. A profitable subsidiary can easily persuade its parent to allow retention of profits for expansion. Even if new investments are more profitable than investment in existing subsidiaries, the parent company may prefer to choose the less risky operation of expanding existing subsidiaries rather than opening up new units. The typical pattern of foreign investment by a firm is to initially set up operations with a very small capital outlay; this is possible since the operations at the early stages of entry into a country may be restricted to a sales outlet or assembly while the more sophisticated stages of production are quite often financed by retained earnings. Parent companies often look upon foreign

[20]E.T. Penrose, op. cit.

retained earnings as 'gambling dollars'[21] and are prepared to take risks with retained earnings that they are unwilling to take with fresh capital. The distinction drawn by foreign companies as well as importing countries between fresh capital inflows and retained earnings can be an effective tool from the viewpoint of the recipient country in meeting its balance of payments problem while at the same time maintaining a favourable climate for fresh foreign private investment.

There is a fundamental psychological difference in the viewpoints of firms which decide to invest abroad and those that choose to exclude overseas investment from their activities. Mere changes in the rates of return on foreign investments are unlikely to make non-investors invest. The guiding factors for foreign investors seem to be the size of the market and the sources of supply of inputs while rates of return are more a function of operational efficiency and minor improvements in these rates are unlikely to change the basic decisions of firms. Reduced taxation by both investing and host countries is, therefore, unlikely to be effective in stimulating foreign investment. As long as non-investors have no idea of the rates of return that they can obtain on foreign investment, an improvement in these 'unknown' rates cannot affect their decision not to invest overseas. As such, a tax incentive cannot be effective in the case of non-investors unless it causes a basic change of their viewpoint.[22]

The tax instrument can, however, affect the decisions of investors in a variety of ways. Both investing and host countries might offer various types of concessions like tax holidays, tax sparing and avoidance of double taxation. Recent changes in U.K. taxation of overseas investment are likely to make home investment more attractive than overseas investment by increasing the taxation on overseas trading corporations. The increased taxation, however, impinges on profits and dividends remitted to the U.K. rather than profits earned. Thus the measure has a bias towards retained earnings. There would, therefore, be an incentive for a country like India to reinforce the bias towards retained earnings by appropriate measures, fiscal and administrative, to facilitate reinvestment of retained earnings. Unlimited

[21] Barlow and Wender, op. cit.
[22] Barlow and Wender, ibid.

growth of retained earnings can have severe balance of payments repercussions, as discussed earlier; nevertheless there is at least a case for encouraging retained earnings where the foreign know-how is vital for the development of a particular sector of industry.

Although an efficient allocation of capital may require tax neutrality, there is a case for stimulating investment from the capital exporting countries to the developing countries through special tax incentives since there are substantial external economies to be reaped from investment in the developing world. Besides, these tax concessions are necessary to counter the 'risk illusion' which invariably tends to exaggerate the real risks involved in investing in developing countries.[23] The provision of investment guarantees and social overhead facilities are, however, more vital than tax incentives in fostering investment in these countries.

To compare *national* returns from foreign and domestic investment, an investing country must compare the *gross* domestic yield with the foreign *net* yield since only the *net* income accrues to the investing country.

PERCENTAGE DISTRIBUTION OF U.S. FOREIGN PRIVATE DIRECT INVESTMENT BY AVERAGE FOREIGN TO DOMESTIC PROFITABILITY RATIOS

Ratio of gross foreign to gross domestic yields	*Percentage of total U.S. Foreign Investment*
3.0	12.3
2.0 to 3.0	31.5
1.0 to 2.0	28.8
Under 1.0	22.6
Ratio of net foreign to net domestic yields	***Percentage of total U.S. Foreign Investment***
3.0	44.8
2.0 to 3.0	12.4
1.0 to 2.0	29.4
Under 1.0	13.6

Source : 'Taxation of Foreign Investment Income—An Economic Analysis'—P.B. Richman (1963).

[23]P.B. Richman, 'Taxation of Foreign Investment Income: Economic Analysis' (1963).

Only a small proportion U.S. capital abroad is invested where the gross return is less than the gross domestic return. About 28 per cent of total U.S. foreign investment was in regions and sectors where the average *gross* rate of return was lower than the average *gross* return in the U.S. in the comparable sector. One-half of this investment was in regions and sectors where the average *net* foreign yield was lower than the domestic yield. Tax differentials could be responsible at the most for the allocation of 14 per cent of foreign investment where the average gross returns were less than comparable domestic returns. Thus, it is clear that taxation has a limited role in stimulating foreign private investment and that the rate of return as derived by various ratios is of limited use in assessing the real rate of return since indirect returns cannot, possibly, be quantified.

Foreign Loans Versus Foreign Equity

As discussed earlier, the typical growth pattern of foreign investment is through government fixed interest loans for infrastructural development followed by direct equity investment, first in the export sector and latter in the import-competing sector. The merits of foreign loans and foreign equity have been discussed both from analytical and empirical viewpoints and this section attempts to survey, briefly, the literature on this subject.

On certain restrictive theoretical assumptions, it is deduced that from the host country's viewpoint foreign loans are more costly than direct foreign investment.[24] The assumptions required for this derivation, i.e. constant costs, full employment and monopoly returns to specialised foreign capital, are too restrictive for any useful policy conclusions. The rate of return on direct equity investment is, in actual practice, higher but this is attributable to the return on non-capital factors including technical and managerial skills. For instance, it is claimed that the Latin American countries pay out a yield of 15 per cent on direct investment for enterpreneurial services

[24] K.J. Rothwell, 'The Extra Cost of Fixed Return Over Equity Foreign Capital', *The Indian Economic Journal*, January-March 1964.

in addition to a real rate of interest on capital.[25]

On empirical grounds it has been argued that loans have created a heavier pressure on India's balance of payments than equities. The total annual outflow on account of direct investment works out at 7 per cent of outstanding capital, made up of 5.7 per cent on account of profits and 1.3 per cent as repatriated capital. The annual outflow in respect of loans is estimated at 11 per cent made up of an interest charge of 4.4 per cent of debt outstanding and repayments in equal annual instalments spread over an average of 15.2 years (i.e., 6.6 per cent). It is admitted that the two methods of finance are different in that the outstanding loan capital is reduced over time while the equity capital is increased by retained earnings though it is claimed that this liability is purely notional.[26] The argument that equity investment is more favourable from a balance of payments standpoint needs more detailed scrutiny, for, apart from repatriation of capital, retained earnings in turn create substantial investment income liabilities which at times can take almost astronomical values. A straight comparison of loan and equity costs is a *non sequitur* because they entail very different things. Direct investment is an entrepreneurial activity of large corporations with organisation, technical and managerial skills, patents, trade marks and marketing channels. Loans are basically a financial transaction providing supplemental funds; hence the substitution of loans for equity is not always possible. However, within limits it is possible to obtain a variety of forms which foreign investments can take, given the necessary information regarding investment opportunities. While developing countries often find the balance of payments burden of foreign equity to be too severe it does not necessarily follow that a loan-cum-technical agreement would be necessarily less onerous. As certain recent proposals indicate, non-financial collaboration arrangements may be more costly than straight capital participation arrangements.

The cost of servicing equity or loan arrangements vary

[25]F. Pazos, 'Private Versus Public Foreign Investment in Under-Developed Areas', in H.S. Ellis (Ed.), *Economic Development for Latin America* (1961).

[26]'Foreign Capital in India', Economic and Scientific Research Foundation Research Paper Two (1965).

according to the *terms* as well as the *duration* of the two types of investment. In an appendix, the time profiles of the direct balance of payments cost of loans versus equity are derived under varying assumptions. As mentioned earlier a comparison of loans versus equities is not strictly correct, but insofar as such *ex ante* comparisons are made in terms of the direct balance of payments effect, it is necessary to compare an individual loan maturity, bearing a given interest rate, with an individual equity investment yielding a given rate of return and with given proportions between remittances abroad and retained earnings. The balance of payments cost at any point of time can be read off the two tables. Given this information, it is possible to make a broad estimate whether a loan is more or less burdensome than an equity investment at the end of a given period from the viewpoint of direct balance of payments costs. Thus, for instance, the direct balance of payments cost of a 25-year loan at 10 per cent interest, with equal annual repayments of the loan, would be 230 per cent of the loan amount by the end of the loan period: the cost at the end of the 20th, 15th, 10th and 5th year would be 205 per cent, 168 per cent, 122 per cent and 66 per cent, respectively. An equity investment with the assumption of a 12 per cent net profit equally distributed between retained and remittance abroad would, over 25 years, create a balance of payments drain of 260 per cent at the end of 25 years in addition to raising the investment liability by a like amount: however, the balance of payments drain at the end of the 20th, 15th, 10th and 5th year would be 168 per cent, 101 per cent, 50.5 per cent and 12.4 per cent, respectively, with corresponding increases in investment liabilities of the same amount as the drain by the end of the respective years. It is clear that the balance of payments profile of the equity investment appears in more favourable light during the earlier years while the loan arrangement is more advantageous over the longer period. Any *a priori* conclusion that, in general, one form of capital investment is cheaper than another would certainly be a *non sequitur*.

The choice before a host country is really not between loans and equity in the aggregate, but rather in opting for different proportions of loans and equities. A low interest long-term loan would naturally cause a lesser strain on the

balance of payments than equity investment. In addition to low interest loans, it is conceivable that a developing country may find it feasible to borrow at higher market rates of interest and still find it cheaper than equity investment. Equity investment invariably entails ancillary, managerial and technical skills; however, this need not necessarily obtain when the equity base is expanded through retained earnings. Since the utility, to the host country, of fresh inflow is different from that of retained earnings, it is not possible to attribute non-capital inflows to total foreign investment. The statements illustratively enable an assessment of the direct foreign exchange costs; the costs and benefits in terms of the impact on the economy cannot be quantified and are therefore beyond the scope of such calculations. The ideal proportion for foreign equity and foreign loans varies from country to country and cannot be defined in terms of an immutable ratio. The flow of non-capital inputs apart, it is possible to approximately gauge the alternative costs of loans *versus* equities. Beyond this, it is not possible to develop a case for either form of financial participation.

Some Concluding Observations on Indian Foreign Investment Policy

Indian foreign investment policy emanates from the 1948 industrial policy resolution and barring certain sectors of industry the policy has been flexible enough to meet the needs of the situation as illustrated by the recent change in policy in relation to foreign investment in the fertiliser industry. The basic guideline for departing from the policy resolution has been the fact that indigenous technology is inadequate, foreign capital unwilling to enter the country without securing majority (and sometimes total) ownership, and the need to meet the foreign exchange cost of import of plant and machinery. Foreign investment in the form of plant and machinery now forms the bulk of fresh inflow. While there is a perceptible tendency to give approval, more readily, to schemes where the foreign exchange costs are covered by foreign equity investment, a project is not approved merely because the foreign exchange expenditure is covered through foreign equity investment since this may quite often result in foreign equity flowing into undesirable channels. What

is really important is the overall pattern of investment and the dovetailing of foreign investment into this overall investment pattern; thus some forms of private foreign investment are rejected even though the entire foreign exchange costs are covered by equity investment while in other cases approval is given to certain key catalytic foreign investments even though the foreign exchange components of the project costs are not covered by equity investment.

Foreign investors quite often expect a net rate of return of about 20 per cent (a level frequently mentioned by the Galloway and Stillman Missions) once capacity production is attained; equity investment yielding such profit margins inevitably creates a serious drain on the balance of payments and unless a country has a strong export item like oil, it cannot afford to allow foreign capital to freely enter the country. As mentioned earlier, the rate of return as measured by the ratio of net profit to net worth is higher on foreign investment in India than the average for all countries. Although the profitability seems markedly lower, particularly in plantations and services, as compared to the 20 per cent return often referred to by prospective investors, the large difference in the rates actually recorded and the 20 per cent demanded by investors may conceivably be attributed to the factor of retained earnings. As mentioned earlier, the investor considers his rate of return on the initial investment, while retained earnings are treated as 'gambling dollars'.

During 1956-61 the annual inflow of fresh private foreign capital averaged less than Rs. 21 crores; during the same period, repatriation of capital averaged Rs. 12 crores, distributed profit Rs. 26 crores and retained earnings Rs. 14 crores. Plantations and services accounted for nearly 45 per cent of profits distributed. As indicated earlier, under certain conditions, loan arrangements may be more advantageous than equity investment; however, each investment needs to be scrutinised separately before deciding whether loan or equity would be feasible. Such a selective approach is more feasible than a blanket policy for any particular sector of foreign investment, as it has salutary effect on the investment climate. Since totally unrestricted flow of foreign investment creates acute balance of payments pressures, the aim of Indian foreign investment policy is to vigorously encourage investments into sectors which are technologically

intensive, so as to ensure that the economy obtains the benefits of foreign equity investment without excessive balance of payments pressures. Thus the outstanding *level* of total foreign equity investment is restricted to a given desirable level, to prevent excessive balance of payments pressures, while the *composition* is kept dynamic enough to enable the economy to derive the benefits of technological advance.

APPENDIX

DERIVATION OF LOAN AMORTISATION AND INTEREST PAYMENTS

L = Loan Amount (assumed as 100)
r = Interest rate
t = Any intermediate year of the loan
n = Duration of the loan
S_t = Sum of Remittances Abroad at the end of 't' years
S_n = Sum of Remittances Abroad at the end of 'n' years.

Then $$S_n = L\left[1+\frac{(n+1)\,r}{2}\right]$$

And $$S_t = \frac{Lt}{n}\left[1+r\left\{\frac{2n-(t-1)}{2}\right\}\right].$$

DERIVATION OF EQUITY INVESTMENT LEVEL AND SUM OF REMITTANCES ABROAD

Let I = Initial Foreign Investment (assumed as 100)
t = Number of Years
k = No. of Years of Nil Return
P_r = Profits Retained
P_a = Profits Remitted Abroad
I_t = Level of Investment at the end of 't' years
$I_t\text{-}I = \Delta I_t$ = Increase in Investment at the end of 't' years
S_t = Sum of Remittances Abroad at the end of 't' years.

Then $$I_t = I\,(1+P_r)^{t-k}$$

and $$S_t = \frac{(\Delta I_t)\,P_a}{P_r}.$$

BALANCE OF PAYMENTS COST OF LOAN ARRANGEMENTS

Duration of loan 'n' years	*Amortisation and Interest Cost as a Percentage of Loan Amount at the end of 't' Years* 5	10	15	20	25 (*Years*)
I. *Interest Rate 7 per cent*					
5	121	—	—	—	—
10	78	138.5	—	—	—
15	63.7	115.7	156	—	—
20	56.5	104.2	143.2	173.5	—
25	52.2	97.5	135.5	167.5	191
II. *Interest Rate 8 per cent*					
5 ..	124	—	—	—	—
10 ..	82	144	—	—	—
15 ..	68.0	122.7	164	—	—
20 ..	61.0	112	153	184	—
25 ..	56.8	105.5	146.5	180	204
III. *Interest Rate 9 per cent*					
5 ..	127	—	—	—	—
10 ..	86	149.5	—	—	—
15 ..	72.3	129.7	172.[illegible]	—	—
20 ..	65.5	119	162.7	194.5	—
25 ..	61.5	113.6	157	192	217
IV. *Interest Rate 10 per cent*					
5 ..	130	—	—	—	—
10 ..	90	155	—	—	—
15 ..	76.7	136.7	180	—	—
20 ..	70	127.5	172.5	205	—
25 ..	66	122	168	205	230

BALANCE OF PAYMENTS COST OF EQUITY INVESTMENT

Assumptions Rate of Return Nil for 3 years thereafter varying net profit rates with varying proportions between retained and remittance on repatriation of capital	*Remittance Cost and Equity Level at the end of 't' Years*				
	5	10	15	20	25 (*Years*)
I NET PROFIT 10 PER CENT					
(*i*) Retained 5% Remittance 5%					
Investment	110.25	140.7	179.5	229.0	292.0
Remittance	10.25	40.7	79.5	129.0	192.0
(*ii*) Retained 4% Remittance 6%					
Investment	108.2	131.6	160.0	195.0	237.0
Remittance	12.3	47.4	90.0	142.5	205.5
(*iii*) Retained 3% Remittance 7%					
Investment	106.1	123.0	143.0	165.5	191.5
Remittance	14.2	53.5	100.0	153.0	214.0
II NET PROFIT 12 PER CENT					
(*i*) Retained 6% Remittance 6%					
Investment	112.4	150.5	201	268	360
Remittance	12.4	50.5	101	168	260
(*ii*) Retained 5% Remittance 7%					
Investment	110.5	140.7	179.5	229	292
Remittance	14.7	57.0	111.5	181	269
(*iii*) Retained 4% Remittance 8%					
Investment	108.2	131.6	160.0	195.0	237.0
Remittance	16.4	63.2	120.0	190.0	274.0

III NET PROFIT 14 PER CENT					
(i) Retained 7% Remittance 7%					
Investment	114.5	160.5	225.0	316.0	441.0
Remittance	14.5	60.5	125.0	216.0	341.0
(ii) Retained 6% Remittance 8%					
Investment	112.4	150.5	201	268	360
Remittance	16.6	67.0	134	224	347
(iii) Retained 5% Remittance 9%					
Investment	110.5	140.7	179.5	229	292
Remittance	18.9	73.5	143.0	232	346
IV NET PROFIT 16 PER CENT					
(i) Retained 8% Remittance 8%					
Investment	116.6	171.5	252	370	542
Remittance	16.6	71.5	152	260	442
(ii) Retained 7% Remittance 9%					
Investment	114.5	160.5	225.0	316.0	441
Remittance	18.7	78.0	161.0	278.0	439
(iii) Retained 6% Remittance 10%					
Investment	112.4	150.5	201	268	360
Remittance	20.7	84.4	167	280	435

26

Concentration of Economic Power*

R.K. Hazari

This paper deals with the problem of concentration of economic power resulting from concentration of control over industry in a handful of prominent business families. The author examines the factors behind the growth of such concentration in India and suggests the kind of public policies that should be adopted, keeping in view the fact that while the Constitution has laid down 'prevention of concentration as one of the Directive Principles of State Policy, an increase in concentration in certain circumstances may have technical and economic advantages. Thus, the policy of granting too many licenses in certain industries with a view to reducing concentration has resulted in creating uneconomic units and has not benefited society. Also economic concentration in India is different from monopoly in the conventional sense.

Editor

1

This study conclusively establishes that there was an increase in the concentration of economic power in the corporate

*Taken from R.K. Hazari, *The Corporate Private Sector: Concentration, Ownership and Control*, Asia Publishing House, London 1966, pp.357-62,

private sector between 1951 and 1958. Whether this development was for the better or the worse from the standpoint of the rate of industrial growth, efficiency and utilisation of resources, etc., cannot be established. It is quite clear, nevertheless, that, by itself, the increase in concentration was inconsistent with the directive principles of state policy laid down under the Constitution and the objectives of planned development stated in the Second and Third Five Year Plans.

If directives and value judgments are set aside and attention is focused on the urgent needs of the economic situation, there is room for honest difference of opinion on whether the increase in concentration that took place between 1951 and 1958 was undesirable and excessive. An increase in concentration has its economic and technical advantages and can do some good.

The share of Tata and Martin Burn in corporate private activity increased during the reference period, largely because these two groups were interested mainly in steel, heavy engineering and power, the three industries which play a key role in industrial development and which require large capital investment per unit of output. Since they were well-established in these lines, prudence required that they should be actively associated with the expansion programmes. Tata and Martin Burn could deliver additional output at a lower unit cost as compared with the new plants to be set up by Government or possible new private entrants. That is not all. They could do it in a shorter period of time for, expanding a plant is in many ways easier than putting up a new one. Their performance was subject to fewer uncertainties for they had the organisation, experience and skill to deal with contingencies. And, above all, they had some spare capacity in labour, equipment and top management which, as subsequent developments have shown, could be turned to national, and not just private, advantage. Experience has justified the expansion permitted to—or imposed upon—Tata and Martin Burn. They have delivered the goods at reasonable cost to the public and less than reasonable return to themselves. If concentration has increased in the process, the price has been worthwhile.

2

What should cause concern is the fact that the two largest Complexes, Tata and Birla accounted for approximately one-fifth of the physical assets of the corporate private sector in 1958. This absolute level of concentration is, in my opinion, certainly excessive. It reflects the continuance of a low level development of resources and entrepreneurship in the economy. That is the basic problem which requires attention.

The measures to combat and reduce the excessive concentration of economic power can be negative or positive. The negative measures would include a break-up of the existing large groups or the placing of an embargo on their further growth. The positive measures have to be less spectacular, more diffused and essentially long term. I am emphatically in favour of positive measures.

3

A break up of the large groups is, legally, impossible and, on economic grounds, unwise.

The law can never provide an adequate definition of corporate groups and their ramified interests. The Companies Act does not define a group, except for the purpose of regulating inter-company loans and investments (section 370) and restricting the number of public companies managed by a managing agent (section 332). This study shows clearly that the statutory definition is inadequate and that a wider definition would also be inadequate in view of the variety of ways in which companies can be controlled.

Assuming that Government draftsmen and legislation win the race against private legal ingenuity, and that the effort and cost are worthwhile, at what level would a group qualify for break-up? If size is the only criterion, would it be judged by share capital, net worth or total capital employed? And how would the break-up be carried out and supervised?

An alternative is to nationalise the large groups. This lacks a precedent[1] since nationalisation in other countries has

[1]The Swedish Government did take over the Kruger group in the

been confined to industries (e.g., U.K.) or individual companies (e.g., France), but that is not the main argument against such a course. The large groups have highly diversified occupations, and, in most cases, include a large number of companies of various sizes. Their legal position as groups is indefinite: the Tata and Martin Burn groups can be identified fairly easily, but many Birla and Dalmia Sahu Jain companies would escape the net. The act of nationalisation would, therefore, be highly discriminatory and would involve the assumption of direct managerial and financial responsibility by Government in diverse economic activities. Besides, it would be a violation of the spirit and letter of the Industrial Policy Statement of 1956.

4

The economic case against the break-up of groups is even stronger. The country lacks organisation even more than it lacks capital. The break-up of the few existing large organisations would entail the loss of the useful experience and skill that have been built up in and by these organisations. This experience and skill is not, as is believed in some circles, confined to financial manipulations. It embraces a much wider field which covers, besides financial management, marketing, technical expertise and managerial cohesion. A group is not just a collection of money and equipment. A group is an organisation larger than the sum total of its components and represents much more than an accumulation of physical and financial assets. It is a body of trained personnel, who have been accustomed to perform their functions in unison and to pool their experience and skill for the advancement of a common purpose. Such organisations can be divided only at the risk of impairing efficiency.

A complete embargo on the growth of the large groups would be suicidal in the present context. Their investment programmes are integral to the over-all development effort,

thirties but that was done in extraordinary circumstances. Kruger committed suicide after his world-wide speculation was discovered. No buyer could be found for his international empire, shrunk though it was after salvage operations.

and are complementary to the public sector programme. Their existing undertakings can expand at a cost lower than that of new undertakings, without requiring a proportionate expansion in overheads and without involving all the difficulties of starting from scratch. There is no justification for allowing the managerial, financial and output capacity of the large groups to go waste. Moreover, the public sector programme itself would be endangered if the units which are part of large groups are not allowed to expand. If Tata Steel, Indian Iron, A.C.C. and Tata Loco, for instance, are not allowed to expand, there would be a shortage of steel, cement and engineering goods required for the public sector.

Risks are inherent in growth but there is a point beyond which it is unwise to take risks. One could think in terms of imposing severe restrictions on the growth of the large groups if one were reasonably confident that others, i.e., small and medium groups, independent and new industrialists, and the State, could set up and expand a wide variety of large scale industries with a speed and efficiency comparable with that expected of the large groups. There are no grounds for such confidence.

5

The anti-trust policy of the U.S. has often been cited in this connection. In the U.S., combinations which restrain or eliminate competition, as well as unfair trade practices, are illegal and are abhorred by the general public, which regards competition as one of the basic values of the American way of life. The U.S. anti-trust policy is, thus, clearly aimed at the promotion of competition.

There is no such well defined objective in India. Competition is not one of the basic values of the Indian way of life. Official policy on industrial and import licensing, in fact, aims at the minimisation or elimination of competition to conserve economic resources. The promotion of competition cannot, in any event, be an effective remedy against the concentration of economic power in India. Concentration is not synonymous with monopoly in this country because, as stressed earlier, every large group has diversified industrial interests. There is

practically no industry which can be said to be the monopoly of a particular group.

We are not suffering from the evils of monopoly in the conventional sense of the term. The common text-book evils of combinations in restraint of trade, like collusion in fixing prices, allocation of markets and restriction of output, are of little relevance in a sellers' market which is expanding rapidly and many features of which have official sanction. What would be called unfair and discriminatory trade practices in the U.S. are known to be quite common here. They are bound to flourish in a country in which a sellers' market has endured for more than twenty years and is expected to last another ten years at least.

6

In one sense, there is, nevertheless, an underlying similarity between the American and Indian attitudes towards concentration. Much of the U.S. antipathy to combinations is based upon the fear that New York financiers, many of whom happen to be Jews, might dominate the entire economy if they are allowed to become more powerful. In India, industrial enterprise is still the practical monopoly of a few castes. Certain regions, moreover, feel that they are industrially backward and that what industries they have, are controlled by 'outsiders'. Much of the latent public feeling against concentration in India has, thus, a caste-cum-regional basis. Part of this feeling is also no doubt attributable to the widely held belief that some people have become so powerful, thanks to their resources and contacts, that they can do practically anything and get away with it.

7

Two long term remedies can be suggested to reduce the concentration of economic power. One is to encourage the growth of medium and small groups and new industrialists, the other to further expand the pubilc sector.

The rapid expansion of the public sector, whatever its merits on other grounds, does not really dilute concentration. It only opposes the massive economic power of the state against

the economic power of the large groups. Those who abhor excessive concentration of power, regardless of who enjoys it, might find it no remedy at all. Realism, nevertheless, demands a compromise. Till such time as the medium and small groups can achieve their 'take-off', only the State can countervail the economic power of the large groups. In the meanwhile, there need be little fear that the large groups will eat up the smaller fry for, the opportunities of expansion are still almost unlimited[2]. This study establishes not merely that concentration of economic power has increased but also that the increase has taken place almost wholly through actual growth, not by means of mergers and other forms of corporate cannibalism. The medium-sized groups, too, have participated vigorously in the general expansion.

The task of public policy is, therefore, to see that, in future, the larger groups do not take away a disproportionate part of the available opportunities. Little reliance can be placed, for the specific purpose of reducing concentration, on the cooperative sector or the small corporate groups. which, their merits on other grounds notwithstanding, have neither the finances nor the organisational capacity to take up and implement large industrial projects. Attention must, therefore, be focused on the medium-sized groups.

8

The medium groups, of which a fairly representative cross-section has been studied here, have demonstrated their ability to mobilise financial and organisational resources for fairly large industrial enterprises. The financial and technical performance of some of them has been even better than that of large groups. The record of Kasturbhai and Mafatlal in cotton, Seshasayee in chemicals, Kirloskar in engineering, and Ramakrishna in sugar and cement, for instance, has been far better in many ways than that of most large groups in the specific industries.

A rational and positive policy for the building up of

[2]Subject, of course, to the availability of foreign exchange, local resources and various kinds of licences, etc., the distribution of which is admittedly biased in favour of the larger groups.

countervailing economic power within the private sector has to be a continuing process, not a once-for-all operation. It must be based on the greatest possible exploitation of the organisational potential in medium-sized groups. This can be done by discriminating in their favour in such matters as licensing of projects, disbursement of foreign exchange and approval of foreign collaboration, supply of power and essential materials, investments of L.I.C. and State Governments, and loans from special financial institutions. Good care would have to be taken, of course, to see that the assistance does not go to large groups masquerading as medium groups, and that the genuine medium groups make proper use of the assistance extended to them.

9

Government spokesmen claimed at one time that the policy of licensing a large number of new units in each industry was meant to disperse economic power. This policy was based upon a complete misunderstanding of the concept and origin of economic power. It might have been appropriate in dealing with a monopolistic situation, but not for curbing the growth of the kind of concentration which exists in India. It is hardly surprising, therefore, that the policy has failed to achieve its stated objective.

The implementation of this policy has actually left a legacy of uneconomical, small-sized plants, to say nothing of the high foreign exchange cost it has entailed. To avoid repetition of this experience, Government must insist upon economic size of plants and the attainment of certain minimum levels of efficiency while giving licenses and assistance to medium groups. If monopoly or near-monopoly, in the traditional sense of the term, is thereby promoted or tolerated, it should be clearly recognised that this is the necessary price which has to be paid for modern technology, till such time as the size of the market for individual products expands sufficiently to permit the economic working of a large number of producers of each product.

10

Towards the end of 1963, the Companies Act was amended

to provide, among other things, for the taking over by the Public Trustee of the voting rights of trusts in companies (section 187B read with section 153A), without taking over the shareholdings and paying compensation for them. The Finance Minister explained that the intention behind this measure was to reduce the concentration of economic power, and to prevent the misuse of trust funds for purposes not intended by the donors. This is a vital and far-reaching change.

In 1958, trusts held a *minimum* of 3 per cent of the total share capital of the 1079 companies covered in this study and 8 per cent of the total controlling block in 888 Inner Circle companies. Their actual holdings must have been larger for technically, a trust could not be registered as a shareholder (section 153) and the classification adopted for this study was based upon inference. In the Tata, Birla, J.K., Shri Ram and Mafatlal groups, particularly, trusts play a key role in the holding of controlling blocks. In most of the other groups, too, trusts appear to play a rather important role.

There is no doubt that the creation and maintenance of trusts is a common and quantitatively significant technique of keeping personal fortunes free of taxes on income and property and, thereby, preventing a dilution of the controlling investments in key companies. The income from the trust investments may be given away in charity (as the Tata and Birla trusts do on a large scale) but the voting power which is conferred by the investments remains intact in the hands of the trustees.

The amendment will definitely discourage the holding of *key* controlling blocks in the names of trusts. This will happen even if the Government, as stated by the Finance Minister, does not actually take over the voting power of trusts or, having taken it over, and entrusted it to the Public Trustee, instructs him not to exercise it. Inter-corporate investments will grow further as a consequence. The dividends and capital gains on these investments will, however, be subject to tax. That is not the only merit of the amendment. In the long run, it will tend to reduce the magnitude of large blocks of tax-free wealth and income available for the purpose of controlling companies and will, to that extent, also tend to curb the concentration of economic power.

27

Operational Controls over the Private Sector*

Gunnar Myrdal

Gunnar Myrdal critically examines here the framework of direct controls over the private organised sector in India and other South Asian countries. The control system is characterised by resort to administrative discretionary controls to an extraordinary extent, so much so that no major decisions can be taken by private business undertakings without the prior permission of several administrative authorities. An oddity resulting usually from controls is that most government officials have to devote most of their time and energy to stopping enterprise rather than encouraging it. A direct consequence of controls is the creation of monopolistic conditions in industry, black markets, and administrative and political corruption. Myrdal also traces the economic and sociological background of the control system.

Editor

1. In the Organized Sector: The Institutional and Ideological Framework

There are in South Asia establishments in private industry,

*Taken from Gunnar Myrdal, *Asian Drama: An Enquiry into the Poverty of Nations*, pp. 916-33. © 1968 by The Twentieth Century Fund, New York. Reprinted by permission.

commerce, and finance that form what is commonly referred to as the 'organized' or the 'modernized' sector of the economy. Within that sector, goods and services are produced for a national and, occasionally, an international market; there economic behaviour is supposed to be rational in the sense that it is based on calculations of costs and revenues and directed at maximizing net returns. The distinction between organized and unorganized economic activity has become a standard conception in all discussion about planning for development, especially in India where the organized sector is fairly large and quite modern in the above sense. To quote Raja J. Chelliah:

> There is a curious mixture of the modern and the primitive in the economy of India....The organized sector is very similar in many respects to an advanced economy. It is responsive to economic stimuli. By contrast, the unorganized sector is tradition-bound and backward, and a considerable part of it is outside the monetary system. It must be remembered that subsistance agriculture and self-consumption still are very much the rule in the rural sector.[1]

As we mentioned, what little discussion there is about operational controls in the plans and in the literature concerns almost entirely the organized sector of the economy, though usually this is not clearly stated. Even though the traditional sector is far larger in all the South Asian countries, the organized sector is particularly important from a planning point of view, as enlarging it and, eventually, causing the traditional sector to adopt its more rational patterns of economic behaviour is a main sightline for planning in the region.

Earlier we pointed out that in South Asia large-scale industry and the organized sector generally have retained many characteristics of the traditional society. Ownership and management show pre-capitalistic traits of paternalism and nepotism. Loyalties to caste, family, and ethnic group play a considerable role; 'connections' are extremely important. Only with

[1]Raja J. Chelliah, *Fiscal Policy in Underdeveloped Countries,* Allen & Unwin Ltd., London, 1960, p. 28.

reservations, therefore, can it be asserted that the enterprises in the organized sector are directed according to a rational consideration of price stimuli as they affect costs and returns; even the foreign-owned plantations, mines, and other industrial or commercial enterprises have quasi-feudal peculiarities as compared with enterprises in the developed Western countries. Some of these non-capitalistic traits are undoubtedly due to the type of operational controls exerted by the states in South Asia (see below). More fundamentally, however, both the character of the enterprises in the organized private sector and the nature of state controls have to be explained in terms of the region's historical legacy of institutions and attitudes.

There are gross imperfections and maladjustments in the markets in which the enterprises in the organized sector buy and sell. This situation is only partly a reflection of the conditions mentioned in the previous paragraph. A more important consideration is that the organized areas exist as enclaves in a much larger 'unorganized' economy, which is for the most part backward and static. To begin with, their demand for labour, as also for managers and technicians, does not operate in markets that show much resemblance to the corresponding markets in Western countries; the same often holds true of the demand for the supplies needed for production. The markets for finished products are also often imperfect in various ways and degrees. The attempt to give a stagnant society dynamism by promoting the advance of its organized sectors, including large-scale industry, creates imbalance—bottlenecks on the one hand and unutilized capacities on the other—because both supply and demand are highly inelastic as compared with the situation in the Western world.

With these reservations, it is nevertheless in regard to the organized sector that price policies and other non-discretionary controls could be expected to be most effective, and we would assume that planners and governments would use this opportunity to the utmost since it would minimize the need for state intervention of the discretionary type to attain the targets of the plans. This approach to the problem of how to control and direct private business would conform to certain general statements of principles in the plans and the literature. The fact is, however, that even in regard to the organized part of

the private sector resort is had to administrative discretionary controls to an extraordinary extent.

One further observation is appropriate at this stage of our analysis of the South Asian pattern of operational controls. With the advent of the Second World War all the Western countries found it necessary to rapidly re-allocate a large part of their productive resources in order to fulfil expanding new needs, the satisfaction of which did not contribute to meeting normal investment and consumption demands. At the same time, and partly for this reason, the international flow of goods and services was disrupted. The resulting combination of bottlenecks and unused capacities presented Western governments with the practical problem of how to adjust the economy to military needs and the needs of the civilian population. The necessary adjustment could not be expected to occur through the operation of market forces, even were costs and returns reconditioned by non-discretionary controls. For social reasons the governing authorities had to freeze many prices and then, partly in order to back up this price control, they had to resort to the rationing and allocation of goods. Thus they rapidly found themselves equipped with a whole system of 'direct' or 'physical' controls, many of which were necessarily of a discretionary type. As colonial powers, they introduced such controls in their territories. In fact, the independent governments that came to power in South Asia after the Second World War often inherited most of their discretionary controls; in any case, the Western wartime controls provided a model for them to copy and develop further.

The need for direct controls, often of a discretionary nature, in the developed Western countries was temporary, and they were gradually abolished as normal peacetime conditions were restored. In the low-elasticity economies of South Asia the need is much greater and more enduring; even in the organized sectors, market conditions are such that the governments must regularly apply discretionary controls to a much greater extent than the Western countries found necessary even in wartime. This analogy points, however, to a rationale for the control system applied in South Asia. The basic reasons are the region's proverty and underdevelopment—which is reflected in the traditional, less than

market-oriented character of business enterprises in an economy where bottlenecks and surpluses are more normal than a balance between demand and supply—and its interest in engendering and directing development.

A great number of the shortages now existing in the organized sector could be overcome by imports. This implies that a scarcity of foreign exchange is in many respects the 'master bottleneck'. This scarcity cannot be overcome to any substantial extent by price policies or other non-discretionary controls. A country in India's or Pakistan's position would need exchange and import controls even if its currency were devalued;[2] in the next section we shall explain why such controls, in turn, necessitate discretionary investment controls of various types. Only if more foreign exchange were available or if import needs were reduced by slowing down development would the need for administrative discretionary controls decrease substantially. The differences among the South Asian countries as regards their resort to these controls—stretching from India and Pakistan at one extreme to Malaya at the other—are explained largely by the relative scarcity of foreign exchange and the relative intensity of their development efforts.

If the character of economic activity, even in the modernized sectors, goes a long way toward explaining the extraordinary extent to which South Asian countries have adopted administrative discretionary controls, there is no doubt that this development is also in line with the authoritarian and patriarchal tradition we have already touched on. It is more natural in South Asia than in the Western world for government to supervise and direct the conduct of private business. From colonial times politicians and civil servants inherited their role as guardians of the people and the superior status that went with it. Combined with these inherited attitudes is a mistrust of capitalism and business people, which often gives a peculiar colouring to the new ideology of planning for development.

2. Negative Discretionary Controls

In India, new security issues of companies are controlled

[2]This is not, by itself, an argument against devaluation.

by the government under the Capital Issues (Control) Act (1947). Under the Industries (Development and Regulation) Act (1951, amended 1953 and 1956) a government license is required for new major undertakings in the industrial field, including any substantial extension of existing plants, or change in their location or in the articles manufactured. A license may specify conditions regarding location, minimum size, and so on. In addition, the government is given the power to investigate the conduct of any industrial enterprise, to issue directives where its records do not seem satisfactory, and, if the directives are not followed, to substitute a new management or even to take it under its own management. To quote the official rules:

> This [supervisory power] includes the control of prices, the licensing of distribution, transport, disposal, acquisition, possession, use or consumption; the prohibition or withholding from sale; the compulsory selling of stocks; the regulation or prohibition of commercial and financial transactions in relation to the article concerned.[3]

The Essential Commodities Act (1955) empowers the Indian government to control, regulate, or prohibit the production, distribution, transport, trade, consumption, or storage of a large number of commodities—all foodstuffs, all principal raw materials, important industrial components, and all iron and steel products—to prescribe their prices, and even to take over stocks on conditions it itself sets. A regular duty of the Indian Tariff Commission is to fix the prices of the products of protected industries so as to limit profits to 8-12 per cent of invested capital; with regard to a 'representative' firm, the law states only that the practice is to 'select units of average size from different centres'.[4] The State Trading Corporation has been given a monopoly of the import—and sometimes, as in the case

[3]India, Government of, *The Registration and Licensing of Industrial Undertakings Rules, 1952 (as modified up to the 1st March, 1957)*, New Delhi, 1957.

[4]India, Government of, *Report of the Fiscal Commission 1949-50*, Vol I, New Delhi, 1950, p. 173. In addition the Commission shall supervise all protected industries, implying a great number of discretionary powers besides fixing the rates of custom protection and prices.

of cement, the acquisition from Indian manufacturers as well—and distribution of a number of important commodities with the object of ensuring a 'fair distribution at reasonable prices'. As in all other South Asian countries that import food-grains, these imports are a state monopoly; the government disposes of them through channels and at prices which it decides on. Wages and labour costs are government controlled by procedures determined by legislative and administrative acts.

Under the Imports and Exports (Control) Act (1947), the government established control over imports and exports, though it is mainly only in regard to the former that they are used with any strictness. Except for certain articles, the import of which is prohibited, and a few articles placed under open general license, all private imports are subject to individual licenses. The reason is, of course, the great scarcity of foreign exchange. In general, essential commodities such as foodstuffs, capital goods, and industrial raw materials are given priority; most other imports are severely limited or prohibited. As the conduct of most individual enterprises and the starting of new ones almost always depends on the entrepreneur's ability to import machines and other production necessities, import and exchange controls are the most necessary and most effective of the whole range of government controls over the modernized sector of the private economy. Because of the scarcity of foreign exchange, the government is compelled to decline many individual requests or to curtail them severely. In practice, the granting of import licenses has to be coordinated closely with the control of capital issues and the licensing of new undertakings or the extension of existing plants.

The consequence of these and other many-faceted and often overlapping negative discretionary controls is not merely that, as in Western countries, private business must operate within a framework set by public laws and regulations. The fact is that *no major and, indeed, few minor, business decisions can be taken except with the prior permission of the administrative authorities or at the risk of subsequent government disapproval.*[5] This

[5]'The official is frequently compelled by law to make the business-man's decision for him on where he should locate his plant, for instance, or on what is a reasonable rate of return on his capital, or on how

implies that 'private' business in India is something entirely different from what it normally is in the Western countries, a point that will be further developed in Section 4. As one Indian commentator puts it:

> It is the Plan which lays down which are the industries to be developed and to what extent, and it is made incumbent on the authorities to make the necessary resources available so that expansion of the private sector, as planned, can be achieved. The means 'by which the targets can be achieved have also to be provided for—so the complicated mechanism of control on capital issues, the State-sponsored investment corporations, import licenses for capital equipment, allocation of maintenance imports and scarce materials.[6]

This statement gives, however, a false impression of the importance of the plans in determining the negative discretionary controls employed. As we mentioned, the plans do not contain any specific directives for the use of operational controls. The legislative acts authorizing the government to institute discretionary controls and the additional rules issued from time to time by the government or the administrative authorities give only the vaguest and most general instructions as to their use and these are often confusing and occasionally contradictory.

It must be noted that all of the negative discretionary controls authorized are never utilized to the full. If they were, no part of the organized sector could be called 'private' in any meaningful sense. The legislative structure referred to represents partly only the delimitation of a wide area within which the government has discretionary power to act, if the need arises. But import and exchange controls have to be

rapidly he should take on local managers, or even on whether he should be permitted to invest in a particular direction at all. These are obviously decisions the official is not well qualified to make. The decisions, therefore, are for the businessman, quite unpredictable; he does not know on what basis they will be made, all that he knows is that his own basis of decision, profit, is one the average official disclaims.' (Maurice Zinkin, *Development for Free Asia*, Chatto & Windus, London, 1956, p. 12)

[6] *Economic Weekly*, 21 December 1963, p. 2059.

applied and with great restrictiveness, and this necessitates the licensing of new industrial undertakings and the exercise of price and market controls. From time to time the scope of those controls that are actually employed is altered by governmental or administrative decision, as are the ways in which they are utilized. Often the need is stressed for greater efficiency and the speedier processing of applications. But as competent administrators are extremely scarce, and in the majority of cases a great number of considerations—often involving separate administrative authorities, as in the licensing of new undertakings—must be taken into account before a decision can be made, there is a narrow limit to what can be accomplished in this direction.[7]

In this section we have focused our attention on India. In Pakistan, despite repeated assertions in the plans and by government spokesmen that administrative discretionary controls should be relaxed and more reliance placed on the price mechanism, the situation is broadly similar to that in India. Sri Lanka has been moving in the same direction and this trend has accelerated as the economic situation has become more strained under the influence of population increase among other factors. A continuation of this development will be all the more likely if Sri Lanka industrial development proceeds more satisfactorily, thus increasing the need for imported goods. Burma and Indonesia have been pushed ever farther in the direction of administrative discretionary controls by the radical bent of their political development and the civil wars that have marked their recent history; at the same time civil strife has tended to decrease the effectiveness of all government controls. Malaya, the Philippines, and Thailand have relatively few negative discretionary controls, though their positive controls, for instance the granting of tax exemptions to new undertakings, are to

[7]For an account of all the administrative hurdles an industrialist must pass when he wants to set up a new industrial plant, see a brilliant anonymous article, 'Government Procedures and Industrial Development,' *Economic Weekly*, Annual Number, February 1964, pp. 265ff. In the article, it is also pointed out how the developed countries practice of giving tied loans and grants complicates the administrative tangle and increases the paper work. Cf. also A.C. Chhatrapati, 'Planning Through Red Tape', *Economic Weekly*, Special Number, July 1961, pp. 1171ff.

an unusual extent a matter for political and administrative discretion. It should be noted that in all of Southeast Asia, as in Sri Lanka discretionary regulations, particularly those pertaining to internal and external trade, have been adopted partly because of the desire to discriminate in favour of majority groups as against ethnic minorities and foreigners. This aim could not be pursued by means of non-discretionary controls.

3. The Cumulative Tendency

In a system of operational controls of the Indian type, the application of one set of controls has a tendency to make necessary the application of others. As we have already pointed out, the scarcity of foreign exchange and the resort to import and exchange controls make the licensing of new undertakings or additions to old ones a matter of urgent necessity. To make fixed prices effective, allocation and rationing are needed; often more far-reaching intervention on the supply side is also required.[8] There is thus a self-perpetuating and expansionary tendency in every system of negative discretionary controls, especially when the economy is suffering from a shortage of domestic supplies and foreign exchange.

Of even greater and more general importance in increasing the need for compensatory negative controls is the system of positive controls applied. All economic planning in South Asia starts out from the idea that development should be pushed. More particularly, it is felt that private enterpise and, specifically, investment in production is in need of promotion and stimulation. This view is commonly held even in India, where the growth of the public sector is a prominent goal in planning.[9] We also find that state undertakings in basic industry and public utilities have the effect, usually intended, of improving conditions for private business.

In addition, a great number of other policies have the

[8]The implication of an official determination to solve India's severe food crisis in 1964 is well developed in D.R. Gadgil, 'Price Policy for Foodgrains', *Economic Weekly*, September 1964, pp. 1561ff.

[9]As Burma, Indonesia and Sri Lanka move in a more radical direction, they may increasingly come to regard private enterprise in the organized sector as undesirable.

object of encouraging investment in the private sector. A major consideration in fixing the prices of goods and services produced in the public sector has been that they should be kept low to encourage private enterprise. Rates of interest in the organized credit market are also held down, partly for this reason, and special credit institutions are created that often provide commercial establishments with credit at less than market rates. Various tax exemptions are given to encourage new business ventures, and the laxity of tax administration works in the same direction. In addition to ordinary customs tariffs, import and exchange controls discriminate against foreign competition and thus permit industries working for the home market to charge higher prices. Moreover, when exchange rates are fixed so low that demand exceeds supply, every enterprise that gets an import license and foreign exchange receives a *de facto* subsidy.[10]

The above is a summary statement of the various devices whereby costs are decreased and/or returns are increased for enterprises in the private sector. The 'too low' cost price established for capital and foreign exchange also tends to spur public investment. In particular, the low rate of interest makes investments with a long gestation period—for instance, investments in large-scale irrigation—seem more profitable than they really are. Such investments have the consequence of decreasing the capital available for private investment and thus lowering the 'ceiling' where they have to be curtailed by discretionary negative controls.

Even though the initial notion that there is too little private enterprise and that it needs to be encouraged is correct, it has actually been encouraged to the extent that it has had to be curbed by discretionary controls, as supplies, particularly of foreign exchange, are not inexhaustible but very limited, the more so since low rates of interest have spurred public investment in certain directions. To begin with, many of the positive operational controls, through which private enterprise is encouraged, cannot be permitted to be non-discretionary.

[10] 'It is common knowledge that each license fetches anything between 100 per cent to 500 per cent of its face-value if sold.' (India, Government of, Ministry of Home Affairs, *Report of the Committee on Prevention of Corruption*, New Delhi, 1964, p. 18; cf. p. 251.)

Administrative discretion must be exercised to determine who shall be serviced by the public sector and who shall receive loans at special rates of interest from finance corporations and, of course, who shall be allotted foreign exchange. But in addition there will be an increased need for the whole paraphernalia of negative discretionary controls outlined in the previous section, and for a more restrictive use of them. In the process of promoting and curtailing business, the government and the administration become directly involved in all phases of private enterprise. In the language of a plan document:

> The State can assist in the fulfilment of the programmes in this [private] sector, partly by *cutting out* undesirable investment—through capital issues control, control over exports and imports and licensing of industries; partly through tax adjustments and *concessions* and in part by way of selective financial *assistance* through the various corporations which have been set up for the purpose. The progress of investment in the private sector has to be constantly watched even as that in the public sector and the necessary adjustments in policy have to be made from time to time.[11]

An odd situation is thus created. While everybody talks about the necessity of encouraging private enterprise, and while a great number of controls are instituted with this end in view, *most officials have to devote most of their time and energy to limiting or stopping enterprise.* This is like driving a car with the accelerator pushed to the floor but the brakes on. The need for a wide range of negative discretionary controls and for placing so many of the positive controls on a discretionary basis is to a large extent the result of applying excessive positive operational controls. With somewhat less encouragement, there would be less need for curtailment. The important point to stress is that encouraging private enterprise beyond practical limits makes necessary a gargantuan bureaucratic system of administrative discretionary controls to harness it.

[11]India, *Second Five Year Plan*, 1956, p. 93. Italics added.

At this point we have to recall the reasons spelled out in Section 1 of the way in which the South Asian countries are compelled to use discretionary controls over the organized private sector on a scale unmatched by the Western countries even in wartime. This analogy suggests that in some cases the government has reason to apply controls working in conflict with one another. However, the principle often stated in the plans, that the controls should be coordinated (Section 2), would imply that those cases should be held to a minimum. The abolition or relaxation of some positive controls would make it possible to reduce the role of administrative discretion and would render some negative controls less necessary. The widespread existence of conflicting controls has thus the implication that there is need of *more* controls and that a *larger* part of them must be of a discretionary type than would otherwise be necessary. This is particularly unfortunate from a development point of view, as one of the most serious bottlenecks in the South Asian countries is the lack of administrators of competence and integrity.[12]

The situation we have described, where controls regularly work in conflict with one another and have a tendency to breed additional controls, is undoubtedly in large part due to a

[12]'The Government embarked upon rapid schemes of economic development. At the same time it increased the number and scope of [discretionary] controls. Along with an increase in the number and nature of the Government's functions there should have been correspondingly an increase in the efficiency of the machinery of administration. On the other hand, on account of the departure of a number of experienced civilian personnel and on account of the relatively inferior quality of the new personnel that were recruited, and also on account of the lack of understanding on the part of the administrative personnel of the significance of the new functions which devolved upon them, the degree of administrative competence was not equal to the new task imposed upon them. This, along with the prevalence of the atmosphere which was psychologically conducive to short and quick gains, led to an increase in the amount of corruption. In spite of the good intentions underlying the control mechanism, the working of controls was far from efficient.' (C.N. Vakil and P.R. Brahmananda, *Planning for a Shortage Economy, The India Experiment,* Vora & Co., Bombay, 1952, pp. 22-23.)

The shortage of administrators is even more pronounced in most of the other South Asian countries.

lack of coordination, that is, to a deficiency in planning. The plans are not operational; they are worked out in aggregate, financial, and fiscal terms and are silent on the system of operational controls to be applied. The natural tendency of the planners and still more of the executors of the plans to set their sights high, but not provide enough non-discretionary restraints to achieve their objective leads to a system of controls full of internal conflicts with the result that it becomes necessary to increase the volume of controls and make them discretionary.[13]

4. The Play of Interests

It would be a great mistake to explain the multiplicity of discretionary controls in South Asia only by reference to the factors we have so far analyzed: the institutional and ideological legacy and the nature of economic activity in South Asian countries (Section 1), and the cumulative tendency inherent in existing systems of operational controls (Section 3). We must perfect our institutional model of the mechanism leading to an overgrowth of administrative discretionary controls by taking into account the play of interests involved. Directing our attention to the organized sector of the economy as before, we have next to note that one major effect of the combination of conflicting controls outlined in the last section must be *extraordinarily high profits for those private enterprises that succeed in running the gauntlet of discretionary positive and negative controls.* From a planning point of view, such profits are 'unnecessarily' high, in the sense that they are not needed in order to call forth the desired volume of investment and enterprise;

[13] 'By applying contemporary growth models and drawing up plans for development solely in terms of the broad economic aggregates, many of these countries have encountered serious difficulties. They have nearly always turned out to be overambitious plans which they were unable to implement. This has impeded the development of revelant pricing mechanisms for their environment—especially in the market for capital. The governments have, therefore, been compelled to use inefficient direct controls to an ever increasing extent; and this has led to greater and greater ineffective bureaucracy dealing with bigger and bigger monopolized industry.' (J.M. Letiche, 'The Relevance of Classical and Contemporary Theories of Growth to Economic Development', *American Economic Review*, Vol. XLIX, No. 2, May 1959, pp. 491-92)

they are a consequence of the price system's not being conditioned to give entrepreneurs the inducements that are 'correct' from the standpoint of plan fulfilment.[14] These 'too high' profits are, moreover, not very effectively soaked up by taxation; even when marginal tax rates are very high, South Asian tax laws contain convenient loopholes, and large-scale tax evasion is the rule.[15]

Extremely high profits would exist even though investment and enterprise were so severely limited by administrative discretionary controls that demands for foreign exchange and other production necessities did not exceed supplies—that is, if the development in any particular sub-sector of the organized sector were brought into 'balance'. Any laxity in the administration of the negative discretionary controls will generally make it necessary to apply these controls more severely in the future, though perhaps in other sub-sectors. In the foreign exchange sector such a tightening of the reins will come about more or less automatically. If permission is given for more investment and enterprise than can be serviced by domestic supplies, the result may be price increases and, perhaps, a general inflation. This will then often be used as an argument for stronger efforts to keep down cost prices for which the government is responsible and maintain an 'overvalued' currency. Such efforts will tend to

[14]'The private capitalist who makes out a case to start an industry and succeeds in obtaining a licence for the same, is in effect obtaining a monopoly in the country with reference to this product.' (C.N. Vakil, 'The Industrial Revolution in India', *Walchand Memorial Lectures*, Bhagwat Mouj Printing Bureau, Bombay, 1961, p. 9.)

[15]The planners are not unaware of this situation. Asoka Mehta explains: 'The private sector really gets away with incentives and concessions....For instance, while it [government policy] accepts that producers and traders have made large incomes from price rises and imports and that sale of foreign goods has brought large gains to certain people, it has failed to mop up these gains....If the States are reluctant to touch the rural vested interests the Centre is not willing to hurt the vested interest in industry and trade....Agriculturists, specially in the top and middle echelons, who have benefited considerably as the result of development, have been relatively undertaxed for political and other non-economic reasons. While in some States industrial magnates have been granted undeserved concessions in the form of lower power tariffs, etc., at the State expense.' (Asoka Mehta, 'The Fourth Five-Year Plan', *Link*, 15 August 1965, p. 48.)

increase the pressure on supplies still further and to enhance the need for negative discretionary controls, while at the same time *raising the rates of profit still higher* for those enterprises that succeed in obtaining the licenses and the foreign exchange.

To the officials entrusted with handling the levers of positive and negative discretionary controls, and the politicians behind them, a natural rationalization of this state of affairs is that the country no longer adheres to a *laissez-faire* policy, but believes in government intervention in order to spur and direct development. The point is not well taken, however, as a better coordinated system of controls—where positive controls did not breed negative controls to the same extent and there was less need for administrative discretionary intervention generally—would be more rational from the planning point of view. But the practices characterized above are in accord with the authoritarian and paternalistic legacy referred to in Section 1. And certainly they give a wealth of power to officials and politicians, and power is always sweet; we shall have some further comments on this point below.

To businessmen who must find a path through the jungle of administrative discretionary controls,[16] the situation may seem more complicated. On the one hand, they are tempted to complain about the heavily bureaucratic regulation of private enterprise, and they are encouraged to take this line by Western business ideology. Outcries against government interference and regimentation will always be raised when businessmen meet in their associations, but no observer can fail to note that the complaints in this case are rather weak and half-hearted. There are several explanations for the muted character of business criticism. For one thing, private entrepreneurs have become so accustomed to the situation that they take it as much for granted as the climate, the observed caste rules, and many other conditions of life. Also, the officials in charge of the discretionary controls are so powerful that the individual private entrepreneur is seldom tempted to challenge the system; since he knows that he will repeatedly have to seek their favour, he is

[16]'Entrepreneurship consists very largely of working round the government regulatory mechanisms.' (K. Mukerj, 'Allocative Efficiency of Controls in Indian Planning', *Economic Weekly*, February 1964, p. 261)

even loath to protest a particular decision.[17] But the main consideration is, of course, that the stakes are high enough to make all the inconveniences worthwhile. The extraordinarily high profits, which are a result of the South Asian pattern of conflicting operational controls, mean that all those who can hope to pass the controls have a powerful vested interest in the continuation of that pattern.[18] Our next question, therefore, is who can entertain such hopes.

We should first note that any system of administrative discretionary controls must tend to favour those who are already active in a field where permission of some sort is needed to continue or to expand production. Giving special consideration to interests already in the field represents one of the few 'objective' criteria for administrative action that can be invoked. From the point of view of the government it also often stands out as the best way of maintaining production and, in case of a desired expansion, of making investment as productive as possible. Those who already are 'in business' are also better informed and have established relations with the key officials. The tie between the

[17]The present writer has often heard that argument advanced in private conversation with businessmen in India. In a letter to the writer, a young Indian businessman explained: 'Rightly or wrongly, they fear that to do so [that is, come out in open criticism] would put them in a bad way for future applications for licences, or that their contracts with the government might run into difficulties or, more still, that revenge on them might be taken by having their income tax returns re-examined.'

Said one member of a seminar in New Delhi: 'Personally I would not wait for the industrialists—I know how timid and demoralised they are, how in a controlled economy they have to worry about their own permits and their own licences and how little many of them seem to care about the way of life in which they profess to believe.' (M.R. Masani, in *Afro-Asian Attitudes*, Selections from. Proceedings of Rhode Seminar by Ayo Ogunsheye *et al.*, Congress for Cultural Freedom, New Delhi 1961, p. 75)

[18]A member of the Indian Planning Commission, T.N. Singh, observed: 'There is a great deal of hue and cry for doing away with controls....I can only say that I ha·· hardly met an industrialist who really wants to do away with all controls. Our industries have up to now grown in a sheltered market because of controls. And most manufacturers seem to prefer sheltered markets.' (T.N. Singh 'Strategy for a Self-Reliant Economy', *A.I.C.C. Economic Review*, 15 August 1963, pp. 62-63.)

government and existing firms is naturally strengthened when the administration seeks cooperation and advice from established enterprises or their trade associations.[19] Those established enterprises best equipped to give advice are mostly the big ones. Also, it is easier for an overburdened administration to deal with a few large concerns than with a number of small firms.

All this tends to restrict competition, favour monopoly and oligopoly, and pamper vested interests. True, the plans and the rules laid down for granting various authorizations, as well as the discussions centering around the plans and the controls, regularly give expression to the view that newcomers and small businessmen should be granted preference in order to counteract the tendency toward a concentration of power.[20] But it is common

[19]'Through regulation and financial aid India is attempting to merge the goals, methods, and even the personnel of public and private enterprise. The new financial institutions bring together representatives of big business and the government. Business representatives are sitting with technical experts and government officials on development councils which have been set up to plan expansion in certain key industries. Prominent businessmen are also members of such tripartite boards as the Labour Panel to the Planning Commission and the Central Advisory Council of Industries designed to implement and to obtain acceptance for the mixed-economy type of planning. Outstanding business leaders along with civil servants serve on the boards of the new State Bank of India (formerly the Imperial Bank with twenty-two per cent of the nation's banking assets), the now nationalized Reserve Bank of India, the Industrial Finance Corporation, the National Industrial Development Corporation, and the Industrial Credit and Investment Corporation to which the government as well as private industry and foreign capital have contributed. Businessmen and civil servants are directors of the new nationalized industrial corporations such as National Air Services, Sindri Fertilizer, Hindustan Cables, government shipyards, steel mills, and so on. Private businessmen are a distinct minority on these boards but they are there.' (H.B. Lamb, 'Business Organization and Leadership in India Today', in Richard L. Park and Irene Tinker, eds., *Leadership and Political Institutions in India*, Princeton University Press, Princeton, 1959, p. 265.)

[20]'The trend in a socialist economy is in favour of minimising the emergence of new large-scale enterprise in the private sector. . . . Preference will ordinarily be given to new entrants when considering proposals for the establishment or the expansion of an industry. It will also be necessary to examine the monopolistic practices that may have developed in the private sector.' (All India Congress Committee, Planning

knowledge that the trend has been, and is, in the opposite direction.[21] The Committee on Distribution of Income and Levels of Living, under the chairmanship of Professor P. C. Mahalanobis, recently issued a report[22] in which this trend was analyzed. The report finds evidence that 'the working of the planned economy has contributed to [the] growth of big companies in India.[23] The latter are favoured by the financial institutions that give long- and medium-term credits, often at bargain rates; they are in a better position to get permission for new capital issues and to borrow from the banking system; and they can better take advantage of tax concessions and rebates.[24] They have almost a monopoly on joint ventures with foreign firms that provide a flow of investment funds and technical know-how from abroad.[25] Also, established businesses and, in particular, large-scale enterprises control the businessmen's organizations and dominate 'business opinion'; often they own

Sub-Committee, *Report of the Ooty Seminar* (May 30-June 5, 1959) New Delhi, September 1959, p. 20)

'Licensing policies should be so operated as to facilitate the entry of new firms, promote medium and small enterprises and exercise due vigilance in regard to the expansion of large businesses.' (India, Government of, Ministry of Information and Broadcasting, *Problems in the Third Plan: A Critical Miscellany*, New Delhi, 1961, p. 11)

Even more recently the same principle has been laid down. 'The Dhebar Committee has now recommended that the Government should take a decision "not to issue any licences for new projects to existing large industrial concentrations".' (*Economic Weekly*, 16 May 1964, p. 831). 'Steps must also be taken to reduce concentration of economic power and resort to monopolistic practices, while simultaneously extending the field for newcomers and fresh talent in all fields.' (India, Government of, Planning Commission, *The Fourth Five Year Plan: A Draft Outline*, New Delhi, 1966, p. 29.)

[21]'The plan helps the continuance of present trends of concentration of economic power and the continued increase in the riches of those classes and regions who are already comparatively the richer.' (D. R. Gadgil, *Economic Policy and Development*, Gokhale Institute of Politics and Economics, Publication No. 30, Sangam Press Ltd., Poona, 1955, p. 140.)

[22]India, Government of, Planning Commission, *Report of the Committee on Distribution of Income and Levels of Living*, Part I, New Delhi, February 1964, Chapter 4.

[23]Ibid., p. 30; cf. p. 53.

[24]Ibid., pp. 30ff.

[25]Ibid., p. 50.

newspapers.[26] Finally, although the report does not go into that wider problem, they are favoured when it comes to obtaining all the numerous licenses and permits that are required for investment and enterprise in India. The report mentions the various measures taken 'for encouraging the growth of new entrepreneurs and small industry', but concludes that they have not been effective in reversing the trend toward a concentration of economic power.[27]

In the present context this means that established businesses and, in particular, large-scale enterprises are greatly favoured by the system of operational controls applied in India. A major explanation of this practice, which is in direct contradiction to stated policy goals, is, of course, that in the specific case a big firm that is already in business offers better prospects for development.[28] If we assume the control system as given, administrative officials may have perfectly valid reasons for giving preference to big firms and, more generally, to firms already in business. These reasons would work themselves out as forces determining the trend even were more scope given to

[26]Economic power is exercised not only through control over production, investment, employment, purchases, sales and prices but also through control over mass media of communication. Of these, newspapers are the most important and constitute a powerful ancillary to sectoral and group interests. It is not, therefore, a matter for surprise that there is so much inter-linking between newspapers and big business in this country, with newspapers controlled to a substantial extent by selected industrial houses directly through ownership as well as indirectly through membership of their boards of directors. In addition, of course, there is the indirect control exercised through expenditure on advertisement which has been growing apace during the Plan periods. In a study of concentration of economic power in India, one must take into account this link between industry and newspapers which exists in our country to a much larger extent than is found in any of the other democratic countries in the world.' (Ibid., pp. 51-52.)

[27]Ibid., p. 54.

[28]It must be pointed out, however, that the growth of big business as such, though indicating the presence of economic concentration does not necessarily mean the deliberate adoption of an anti-social policy. There is such a thing as the economy of scale which works in favour of big business, on purely economic grounds; and economic considerations are certainly relevant especially in the context of our scarce resources and the imperative need for our making the most economic utilisation of these resources.' (Ibid., p. 35.)

non-discretionary controls, and they would influence the administrative decisions to be taken in a system with fewer discretionary controls. The point here is that the present system tends to give big established firms additional oligopoly power by placing obstacles in the way of the birth of new firms or the expansion of small firms. According to a United Nations analysis:

> The small business units and the newcomers in enterprise are particularly hindered and discouraged by the multiplicity of controls, for their economic power is so weak that they can hardly deal effectively with the control authorities and cope with the delays and red tape involved. On the other hand, existing large enterprises enjoy a comfortable semimonopoly position under the protection of controls and make easy profits through access to the scarce factors made available to them cheaply. There is hardly any incentive for them to improve productivity or operating efficiency.[29]

It is apparent that big business concerns have good reason to support the prevailing system of conflicting and discretionary operational controls. The solid basis for that vested interest is the oligopoly power and the extremely high profits the system affords them. Important businessmen find it very much worth their while to break their way through the jungle of administrative discretionary controls, planted to keep the volume of investment and enterprise down to the level where demands can be satisfied by supplies. For whenever they succeed in getting a permit, a license, a loan, or an allocation of foreign exchange, they get a gift. As the system operates, they are the ones who have the best chances of getting the paper slips that are worth money. It is natural that they should become weary of the mesh of bureaucracy they have to cope with and that they occasionally complain. But, though it is never spelled out, they must be aware of the fact that the overgrowth of administrative discretionary controls is an effect of, and a condition for, the low cost-prices

[29]United Nations, Economic Commission for Asia and the Far East, *Economic Bulletin for Asia and the Far East*, Vol. XII, No. 3, December 1961, p. 7.

and the lack of competition that ensure them of very high profits.

That the officials and politicians who operate the controls also have a vested interest in their preservation and further proliferation is even more obvious. We have already pointed to the power they acquire by virtue of the fact that so many controls are discretionary.[30] This power is the greater as the controls are not integrated in the plans and the directives governing their use tend to be vague; application is a matter of administrative judgment. As we have also pointed out, there will often be good reasons to decide in favour of established, large-scale firms, so they can preserve a good conscience.

But in a setting where caste, family, economic and social status, and, more generally, 'connections' traditionally mean so much, the risk of collusion is great—and it extends from the upper strata in the capitals down to the villagers. The result is often plain corruption. Indeed, the prevalence of discretionary controls invites dishonesty. A report of a United States Economic Survey Team states:

> It should...be recognized that the operation of direct controls invests power in administrative officials to grant licenses, to overlook violations of regulations, and to do other favours for people who...find such special dispensations valuable and can afford to pay much for them. These controls therefore add greatly to the incentives for, and the rewards of graft and corruption. The problem of graft is the Siamese twin of direct controls.[31]

[30]The President of the International Finance Corporation, speaking to the 1961 meeting of the Board of Governors, testified in cautious words: 'Even limited experience in dealing with officials in some countries reveals that they are largely influenced by what will give them the greatest personal power and rewards. The greater the control in government hands, the more personally lucrative can be the exercise of such control.' (Address by Robert L. Garner at the 1961 meeting of the Board of Governors, *International Finance Corporation Bulletin*, Vienna, September 21, 1961, p. 10.)

[31]United States, Government of, Economic Survey Team to Indonesia, *Indonesia Perspective and Proposals for United States Economic Aid*, Yale University Southeast Asia Studies, New Haven, 1963, p. 110.

Quite apart from any moral considerations, corruption puts sand in the economic machinery; it is a force slowing down development. The crucial role of South Asia's system of discretionary controls in undermining morality should not be underestimated. When during and after the war Western countries had to rely on a plethora of discretionary controls, black markets proliferated and corruption spread in spite of their very superior administrative machinery and personnel. There is circular causation with cumulative effects in the sense that a corrupt body of administrators and politicians will have an interest in preserving and building up discretionary controls that give them the opportunity to enrich themselves.

The Future of the Industrial System*

John Kenneth Galbraith

This essay can be regarded as an attempt at sociological prognostication, based on the increasingly acute problem of reconciling two insistent demands. The first is the demand of technostructure, arising from the functional necessity of managing complex and large-sized plants, for autonomy of decision-making. The term autonomy looks innocuous but leads to the most touchy problem of concentrated economic power when an individual business has grown to a mammoth size. The second is the demand arising from the need to satisfy public goals, a responsibility of the modern State. The problem of reconciling the two demands in question has brought about a sort of fusion of the industrial system, even in private enterprise economies, with governmental administration, as evident from the acceptance of planning and the various forms of government controls.

Editor

1

In the latter part of the last century and the early decades of this, no subject was more discussed than the future of

*Taken from John Kenneth Galbraith, *The New Industrial State*, Hamish Hamilton, London, 1967, pp. 388-99. Reprinted by permission of the author.

capitalism. Economists, men of unspecific wisdom, Chautauqua lecturers, editorial writers, knowledgeable ecclesiastics and socialists contributed their personal revelation. It was taken for granted that the economic system was in a state of development and in time would transform itself into something hopefully better but certainly different. Socialists drew strength from the belief that theirs was the plausible next stage in a natural process of change.

The future of the industrial system, by contrast, is not discussed. The prospect for agriculture is subject to debate—it is assumed to be in course of change. So are the chances for survival for the small entrepreneur or the private medical practitioner. But General Motors, General Electric and U.S. Steel are viewed as an ultimate achievement. One does not wonder where one is going if one is already there.

Yet to suppose that the industrial system is a terminal phenomenon is, *per se*, implausible. It is itself the product, in the last sixty years, of a vast and autonomous transformation. During this time the scale of the individual corporation has grown enormously. The entrepreneurial corporation has declined. The technostructure has developed, removed itself from control by the stockholders and acquired its own internal sources of capital. There has been a large change in its relations with the workers and a yet larger one in its relations with the state. It would be strange were such a manifestation of social dynamics to be now at an end. So to suggest is to deny one of the philosophical tenets of the system itself, one that is solemnly articulated on all occasions of business ritual—conventions, stockholders' meetings, board meetings, executive committee meetings, management development conferences, budget conferences, product review meetings, senior officer retreats and dealer relations workshops. It is that change is the law of economic life.

The future of the industrial system is not discussed partly because of the power it exercises over belief. It has succeeded, tacitly, in excluding the notion that it is a transitory, which would be to say that it is a somehow imperfect, phenomenon. More important, perhaps, to consider the future would be to fix attention on where it has already arrived. Among the least enchanting words in the business lexicon are planning,

government control, state support and socialism. To consider the likelihood of these in the future would be to bring home the appalling extent to which they are already a fact. And it would not be ignored that these grievous things have arrived, at a minimum with the acquiescence and, at a maximum, on the demand, of the system itself.

2

Such reflection on the future would also emphasize the convergent tendencies of industrial societies, however different their popular or ideological billing; the convergence being to a roughly similar design for organization and planning. A word in review may be worthwhile. Convergence begins with modern large-scale production, with heavy requirements of capital, sophisticated technology and, as a prime consequence, elaborate organization. These require control of prices and, so far as possible, of what is bought at those prices. This is to say that planning must replace the market. In the Soviet-type economies, the control of prices is a function of the state. The management of demand (eased by the knowledge that their people will mostly want what Americans and Western Europeans already have) is partly by according preference to the alert and early-rising who are first to the store; partly, as in the case of houseroom, by direct allocation to the recipient; and partly, as in the case of automobiles, by making patience (as well as political position or need) a test of eligibility. With us this management is accomplished less formally by the corporations, their advertising agencies, salesmen, dealers and retailers. But these, obviously, are differences in method rather than purpose. Large-scale industrialism requires, in both cases, that the market and consumer sovereignty be extensively superseded.

Large-scale organization also requires autonomy. The intrusion of an external and uninformed will is damaging. In the non-Soviet systems this means excluding the capitalist from effective power. But the same imperative operates in the socialist economy. There the business firm seeks to minimize or exclude control by the bureaucracy. To gain autonomy for the enterprise is what, in substantial measure, the modern

Communist theoretician calls reform. Nothing in our time is more interesting than that the erstwhile capitalist corporation and the erstwhile Communist firm should, under the imperatives of organization, come together as oligarchies of their own members. Ideology is not the relevant force. Large and complex organizations can use diverse knowledge and talent and thus function effectively only if under their own authority. This, it must be stressed once more, is not autonomy that subordinates a firm to the market. It is autonomy that allows the firm authority over its planning.

The industrial system has no inherent capacity for regulating total demand—for insuring a supply of purchasing power sufficient to acquire what it produces. So it relies on the state for this. At full employment there is no mechanism for holding prices and wages stable. This stabilization too is a function of the state. The Soviet-type systems also make a careful calculation of the income that is being provided in relation to the value of the goods available for purchase. Stabilization of wages and prices in general is, of course, a natural consequence of fixing individual prices and wage rates.

Finally, the industrial system must rely on the state for trained and educated manpower, now the decisive factor of production. So it also is under socialist industrialism. A decade ago, following the flight of the first Sputnik, there was great and fashionable concern in the United States for scientific and technical education. Many argued that the Soviet system, with its higher priority for state functions, among which education is prominent, had a natural advantage in this regard.

Thus convergence between the two ostensibly different industrial systems occurs at all fundamental points. This is an exceedingly fortunate thing. In time, and perhaps in less time than may be imagined, it will dispose of the notion of inevitable conflict based on irreconcilable difference. This will not be soon agreed. Marx did not foresee the convergence and he is accorded, with suitable interpretation, the remarkable, even supernatural, power of forseeing all. Those who speak for the unbridgeable gulf that divides the free world from the Communist world and free enterprise from Communism are protected by an equally ecclesiastical faith that whatever the evolution of free enterprise may be, it cannot conceivably come to resemble

socialism. But these positions can survive the evidence only for a time. Only the most committed ideologist or the most fervent propagandist can stand firm against the feeling that an increasing number of people regard him as obsolete. Vanity is a great force for intellectual modernization.

To recognize that industrial systems are convergent in their development will, one imagines, help toward agreement on the common dangers in the weapons competition, on ending it or shifting it to more benign areas. Perhaps nothing casts more light on the future of the industrial system than this, for it implies, in contrast with the present images, that it could have a future.

3

Given the deep dependence of the industrial system on the state and the nature of its motivational relationship to the state, i.e., its identification with public goals and the adaptation of these to its needs, the industrial system will not long be regarded as something apart from government. Rather it will increasingly be seen as part of much larger complex which embraces both the industrial system and the state. Private enterprise was anciently so characterized because it was subordinate to the market and those in command derived their power from ownership of private property. The modern corporation is no longer subordinate to the market: those who run it no longer depend on property ownership for their authority. They must have autonomy within a framework of goals. But this fully allows them to work in association with the bureaucracy, and, indeed, to perform for the bureaucracy tasks that it cannot do, or cannot do as well, for itself. In consequence, so we have seen, for tasks of technical sophistication, there is a close fusion of the industrial system with the state. Members of the technostructure work closely with their public counterparts not only in the development and manufacture of products but in advising them of their needs. Were it not so celebrated in ideology, it would long since have been agreed that the line that now divides public from so-called private organization in military procurement, space exploration and atomic energy is so indistinct as to be nearly imperceptible.

Men move easily across the line. On retirement, admirals and generals, as well as high civil servants, go more or less automatically to the more closely associated industries. One experienced observer has already called these firms the 'semi-nationalized' branch of the economy.[1] It has been noted, 'the market mechanism, [is replaced by]. . .the administrative mechanism. For the profit share of private entrepreneurs, it substitutes the fixed fee, a payment in lieu of profits foregone. And for the independent private business unit, it substitutes the integrated hierarchical structure of an organization composed of an agency. . .and its contractors.'[2]

The foregoing refers to firms which sell most of their output to the government—to Boeing which (at this writing) sells 65 per cent of its output to the government; General Dynamics which sells a like percentage; Raytheon which sells 70 per cent; Lockheed which sells 81 per cent; and Republic Aviation which sells 100 per cent.[3] But firms which have a smaller proportion of sales to the government are more dependent on it for the regulation of aggregate demand and not much less so for the stabilization of wages and prices, the underwriting of especially expensive technology and the supply of trained and educated manpower.

So comprehensive a relationship cannot be denied or ignored indefinitely. Increasingly it will be recognized that the mature corporation, as it develops, becomes part of the larger administrative complex associated with the state. In time the line between the two will disappear. Men will look back in amusement at the pretence that once caused people to refer to General Dynamics and North American Aviation and A.T. & T. as *private* business.

Though this recognition will not be universally welcomed, it will be healthy. There is always a presumption in social

[1]Murray L. Weidenbaum, 'The Defense-Space Complex: Impact on Whom?' *Challenge, The Magazine of Economic Affairs*, April 1956. Professor Weidenbaum is a former employee of Boeing.

[2]From a study by Richard Tybout, *Government Contracting in Atomic Energy*, University of Michigan Press, Ann Arbor, 1956, p. 175. Professor Tybout is referring especially to cost-plus-fixed-fee contracts.

[3]Data from Michael D. Reagan, *Politics, Economics and the General Welfare*, Scott, Foresman and Company, Chicago, 1965, p. 113.

matters in favour of reality as opposed to myth. The autonomy of the technostructure is, to repeat yet again, a functional necessity of the industrial system. But the goals this autonomy serves allow some range of choice. If the mature corporation is recognized to be part of the penumbra of the state, it will be more strongly in the service of social goals. It cannot plead its inherently private character or its subordination to the market as cover for the pursuit of different goals of particular interest to itself. The public agency has an unquestioned tendency to pursue goals that reflect its own interest and convenience and to adapt social objective thereto. But it cannot plead this as a superior right. There may well be danger in this association of public and economic power. But it is less if it is recognised.

Other changes can be imagined. As the public character of the mature corporation comes to be recognized, attention will doubtless focus on the position of the stockholder in this corporation. This is anomalous. He is a passive and functionless figure, remarkable only in his capacity to share, without effort or even without appreciable risk, in the gains from the growth by which the technostructure measures its success. No grant of feudal privilege has ever equalled, for effortless return, that of the grandparent who bought and endowed his descendants with a thousand shares of General Motors or General Electric. The beneficiaries of this foresight have become and remain rich by no exercise of effort or intelligence beyond the decision to do nothing, embracing as it did the decision not to sell. But these matters need not be pursued here. Questions of equity and social justice as between the fortuitously rich have their own special expertise.

4

Most of the individual development which are leading, if the harshest term may be employed, to the socialization of the mature corporation will be conceded, even by men of the most conservative disposition. The control by the mature corporation over its prices, its influence on consumer behaviour, the euthanasia of stockholder power, the regulation by the state of aggregate demand, the effort to stabilize prices and wages,

the role of publicly supported research and development, the role of military, space and related procurement, the influence of the firm on these government activities and the modern role of education are, more or less, accepted facts of life.

What is avoided is reflection on the consequence of putting them all together, of seeing them as a system. But it cannot be supposed that the principal beams and buttresses of the industrial system have all been changed and that the structure remains as before. If the parts have changed, so then has the whole. If this associates the mature corporation inextricably with the state, the fact cannot be exorcised by a simple refusal to add.

It will be urged, of course, that the industrial system is not the whole economy. Apart from the world of General Motors, Standard Oil, Ford, General Electric, U.S. Steel, Chrysler, Texaco. Gulf, Western Electric and Du Pont is that of the independent retailer, the farmer, the shoe repairman, the bookmaker, narcotics peddler, pizza merchant and that of the car and dog laundry. Here prices are not controlled. Here the consumer is sovereign. Here pecuniary motivation is unimpaired. Here technology is simple and there is no research or development to make it otherwise. Here there are no government contracts; independence from the state is a reality. None of these entrepreneurs patrol the precincts of the Massachusetts Institute of Technology in search of talent. The existence of all this I concede. And this part of the economic system is not insignificant. It is not, however, the part of the economy with which this book has been concerned. It has been concerned with the world of the large corporation. This too is important; and it is more deeply characteristic of the modern industrial scene than the dog laundry or the small manufacturer with a large idea. One should always cherish his critics and protect them where possible from foolish error. The tendency of the mature corporation in the industrial system to become part of the administrative complex of the state ought not to be refuted by appeal to contrary tendencies outside the industrial system.

Some who dislike the notion that the industrial system merges into the state in its development will be tempted to assault not the tendency but those who adumbrate it. This, it must be urged, is not in keeping with contemporary ethics and

manners. Once the bearers of bad tidings were hanged, disembowelled or made subject to some other equally sanguinary mis-treatment. Now such reaction is regarded as lacking in delicacy. A doctor can inform even the most petulant client that he has terminal cancer without fear of adverse physical consequences. The aide who must advise a politician that a new poll shows him to be held in all but universal distaste need exercise only decent tact. Those who find unappealing the present intelligence are urged to exercise similar restraint.

They should also be aware of the causes. It is part of the vanity of modern man that he can decide the character of his economic system. His area of decision is, in fact, exceedingly small. He could, conceivably, decide whether or not he wishes to have a high level of industrialization. Thereafter the imperatives of organization, technology and planning operate similarly, and we have seen to a broadly similar result, on all societies. Given the decision to have modern industry, much of what happens is inevitable and the same.

5

The two questions most asked about an economic system are whether it serves man's physical needs and whether it is consistent with his liberty. There is little doubt as to the ability of the industrial system to serve man's needs. As we have seen, it is able to manage them only because it serves them abundantly. It requires a mechanism for making men want what it provides. But this mechanism would not work—wants would not be subject to manipulation—had not these wants been dulled by sufficiency.[4]

The prospects for liberty involve far more interesting questions. It has always been imagined, especially by conservatives, that to associate all, or a large part, of economic activity with the state is to endanger freedom. The individual and his preferences, in one way or another, will be sacrificed to the needs and conveniences of the apparatus created

[4]As indicated in Chapter XXI (and as I have urged at length on other occasions), it excludes the unqualified and the unfortunate from its beneficence.

ostensibly to serve him. As the industrial system evolves into a penumbra of the state, the question of its relation to liberty thus arises in urgent form. In recent years, in the Soviet-type economies, there has been an ill-concealed conflict between the state and the intellectuals. In essence, this has been a conflict between those for whom the needs of the government, including above all its needs as economic planner and producer of goods, are pre-eminent and those who assert the high but inconvenient claims of uninhibited intellectual and artistic expression. Is this a warning?

The instinct which warns of dangers in this association of economic and public power is sound. It comes close to being the subject of this book. But conservatives have looked in the wrong direction for the danger. They have feared that the state might reach out and destroy the vigorous, money-making entrepreneur. They have not noticed that, all the while, the successors to the entrepreneur were uniting themselves ever more closely with the state and rejoicing in the result. They were also, and with enthusiasm, accepting abridgement of their freedom. Part of this is implicit in the subordination of individual personality to the needs of organization. Some of it is in the exact pattern of the classical business expectation. The president of Republic Aviation is not much more likely in public to speak critically, or even candidly, of the Air Force than is the head of the Soviet *combinat* of the ministry to which he reports. No modern head of the Ford Motor Company will ever react with the same pristine vigour to the presumed foolishness of Washington as did its founder. No head of Montgomery Ward will ever again breathe defiance of a President as did Sewell Avery. Manners may be involved. But it would also be conceded that 'too much is at stake'.

The problem, however, is not the freedom of the businessman. Business orators have spoken much about freedom in the past. But it can be laid down as a rule that those who speak most of liberty are least inclined to use it. The high executive who speaks fulsomely of personal freedom carefully submits his speeches on the subject for review and elimination of controversial words, phrases and ideas, as befits a good organization man. The general who tells his troops, and the world, that they are in the forefront of the fight for freedom

is a man who has always submitted happily to army discipline. The high State Department official, who adverts feelingly to the values of the free world extravagantly admires the orthodoxy of his own views.

The danger to liberty lies in the subordination of belief to the needs of the industrial system. In this the state and the industrial system will be partners. This threat has already been assessed, as also the means for minimizing it.

6

If we continue to believe that the goals of the industrial systems—the expansion of output, the companion increase in consumption, technological advance, the public images that sustain it—are coordinate with life, then all of our lives will be in the service of these goals. What is consistent with these ends we shall have or be allowed; all else will be off limits. Our wants will be managed in accordance with the needs of the industrial system; the policies of the state will be subject to similar influence; education will be adapted to industrial need; the disciplines required by the industrial system will be the conventional morality of the community. All other goals will be made to seem precious, unimportant or antisocial. We will be bound to the ends of the industrial system. The state will add its moral, and perhaps some of its legal power to their enforcement. What will eventuate, on the whole, will be the benign servitude of the household retainer who is taught to love her mistress and see her interests as her own, and not the compelled servitude of the field hand. But it will not be freedom.

If, on the other hand, the industrial system is only a part, and relatively a diminishing part, of life, there is much less occasion for concern. Aesthetic goals will have pride of place; those who serve them will not be subject to the goals of the industrial system; the industrial system itself will be subordinate to the claims of these dimensions of life. Intellectual preparation will be for its own sake and not for the better service to the industrial system. Men will not be entrapped by the belief that apart from the goals of the industrial system—apart from the production of goods and income by progressively more advanced technical methods—there is nothing important in life.

The foregoing being so, we may, over time, come to see the industrial system in fitting light as an essentially technical arrangement for providing convenient goods and services in adequate volume. Those who rise through its bureaucracy will so see themselves. And the public consequences will be in keeping, for if economic goals are the only goals of the society it is natural that the industrial system should dominate the state and the state should serve its ends. If other goals are strongly asserted, the industrial system will fall into its place as a detached and autonomous arm of the state, but responsive to the larger purposes of the society.

We have seen wherein the chance for salvation lies. The industrial system, in contrast with its economic antecedents, is intellectually demanding. It brings into existence, to serve its intellectual and scientific needs, the community that, hopefully, will reject its monopoly of social purpose.